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ALEXANDER L. STEVAS,

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

AWECO, INC. AND
UNITED-AMERICAN CAR CO.,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Frank C. Jones
Counsel of Record
Walter W. Driver, Jr.
James A. Pardo, Jr.
KING & SPALDING
2500 Trust Company Tower
Atlanta, Georgia 30303
(404) 572-4600
Attorneys for Petitioner United-American Car Co.

D. M. Lynn
Counsel of Record
Stuart M. Reynolds, Jr.
MOORE & PETERSON
A Professional Corporation
2800 First City Center
Dallas, Texas 75201-4621
(214) 754-4800
MAHON & WINSTON
2430 One Main Place
Dallas, Texas 75250
Attorneys for Petitioner AWECO, Inc.

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QUESTIONS PRESENTED

1. Whether the court of appeals, in conflict with provisions of the Bankruptcy Code and the expressed intention of Congress, erred in applying the absolute priority rule developed under Chapter X of the repealed Bankruptcy Act to a compromise in a Chapter 11 bankruptcy case that is not being approved as part of a plan of reorganization pursuant to 11 U.S.C. § 1129(b) (1982)?

2. Whether the court of appeals applied a standard of review contrary to that prescribed by this Court in *Protective Committee v. Anderson*, 390 U.S. 414 (1968), and contrary to that adopted by the United States Court of Appeals for the Eighth Circuit in *In re Flight Transportation Corporation Securities Litigation*, 730 F.2d 1128 (8th Cir. 1984), to reverse the bankruptcy court's and the district court's determinations that a preconfirmation compromise was in the best interests of the debtor, its estate, and its creditors?[1]

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[1]The following were parties to the proceedings in the court of appeals:

Plaintiffs: United States of America

Defendants: AWECO, Inc. (Debtor); United-American Car Co.

The following are subsidiaries, affiliates or parents of named parties listed pursuant to Sup. Ct. R. 28.1:

AWECO, Inc.: Lake Charles Refining Co. (85% owned subsidiary); MDH Oil & Gas Co., Inc. (66⅔% owned subsidiary); Marilyn Hargis (affiliate); William K. Hargis (affiliate); G. Michael Hargis (affiliate).

United-American Car Co.: The Lamson & Sessions Co. (parent-owner); Youngstown Steel Door Company (affiliate); Camel Company Limited (affiliate); Ewor Corporation (affiliate); Lamson & Sessions GmbH (affiliate); Valley Bolt Corporation of America (affiliate); Valley-Todeco, Inc. (affiliate).

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit (Goldberg (Senior Judge), Gee and Tate, JJ.) is officially reported at 725 F.2d 293 (5th Cir. 1984) and is set forth in the Appendix beginning at page A-1. The opinion of the United States District Court for the Northern District of Texas (Porter, J.) and the findings of fact and conclusions of law of the United States Bankruptcy Court for the Northern District of Texas (Gandy, J.) whose judgments were reversed by the court of appeals, are unreported and are set forth in the Appendix beginning, respectively, at pages B-1 and C-1.

JURISDICTION

The judgment of the court of appeals was entered on February 21, 1984. App. D-1.[2] Petitioners' timely petitions for rehearing and suggestions for rehearing *en banc* were denied on April 23, 1984. App. E-1. This petition is filed within 90 days of those denials. *See* 28 U.S.C. § 2101(c) (1982); Sup. Ct. R. 20.4. On May 8, 1984, the court of appeals stayed the issuance of the mandate up to and including June 7, 1984, pending application to this Court for a writ of certiorari. *See* Fed. R. App. P. 41(b). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) (1982).

STATUTORY AND RELATED PROVISIONS

The texts of sections 1125 and 1129 of the Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 1125, 1129 (1982), of sections 27 and 221 of the Bankruptcy Act of 1898, 11 U.S.C. §§ 50, 621 (1976) (repealed effective Oct. 1, 1979), of former Bankruptcy Rule 919, and of current Bankruptcy Rule 9019 are set forth in the Appendix beginning at page F-1.

STATEMENT OF THE CASE

On December 27, 1979, Petitioner United-American Car Co. ("United") filed suit in Georgia against Petitioner-Debtor AWECO, Inc. ("Aweco") for breach of contract caused by the alleged failure of Aweco to accept delivery of $40,000,000 of railroad boxcars manufactured and to be manufactured by United pursuant to executed contracts with Aweco. On February 24, 1981, Aweco filed a petition under Chapter 11 of the Bankruptcy Reform Act of 1978 in the United States

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[2]References are to the materials reprinted in the Appendices hereto.

Bankruptcy Court for the Northern District of Texas.[3] After protracted negotiations, during which Aweco consulted regularly both with its court appointed Examiner and with the Creditors' Committee, United and Aweco agreed to compromise and settle the litigation. App. A-3; B-1. The settlement involved the payment and transfer by Aweco to United of cash, notes and property having an estimated total value of approximately $5,300,000 (31% of United's net claim after resale of the completed boxcars) and was subject to the approval of the bankruptcy court. App. A-3; B-1; C-3.

Pursuant to Bankruptcy Rule 919 (a)[4] , notice of intention to settle was sent to all parties on November 17, 1981. The Creditors' Committee, the Internal Revenue Service ("IRS"), the Department of Energy ("DOE") and Sutton Investments, Inc. ("Sutton") each filed a notice objecting to the proposed settlement. App. A-3; C-1. Sutton alleged a secured claim. The IRS alleged a secured claim in the amount of approximately $4,000,000 and a priority claim of approximately $2,000,000. App. A-4; B-8. The DOE and United are unliquidated and disputed unsecured creditors.

The bankruptcy judge held a hearing on the proposed settlement at which he received evidence on the settlement and heard argument from counsel for all parties. The settlement was

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[3]The jurisdiction of the bankruptcy court, the court of first instance, was invoked pursuant to 28 U.S.C. § 1471 (1982), and appeal was taken to the district court pursuant to 28 U.S.C. § 1334 (1982), both as provided by section 405 of the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, 2685 (1978).

[4]Bankruptcy Rule 919(a) was part of the Bankruptcy Rules promulgated through the 1970's to implement the provisions of the Bankruptcy Act of 1898, as amended. These rules remained in effect, and generally were applicable to cases arising under the Bankruptcy Code, until the adoption of the current Rules of Bankruptcy Procedure. The provisions of former Rule 919(a) are altered in Bankruptcy Rule 9019(a).

endorsed by Aweco, the Examiner, and the Creditors' Committee. App. C-3. The evidence offered at the hearing uniformly supported approval of the settlement as no objecting party offered evidence in opposition to approval.[5]

On December 31, 1981, the bankruptcy judge entered an Order approving the settlement. App. C-1. That Order expressly considered the probability of success in the pending litigation, the uncertainties in fact and law, the complexity and likely duration of the litigation, and the attendant expenses, inconvenience and delay that would result from continuing the litigation. App. C-1-2. The bankruptcy judge made seventeen specific findings of fact in support of his conclusions. App. B-4; C-2-4.

On January 8, 1982, the IRS and the DOE filed a motion for rehearing and on February 1, 1982, the bankruptcy court conducted an additional hearing. Aweco and the Examiner presented additional testimony in favor of the settlement, but the IRS again failed to offer any conflicting evidence.

All of the evidence presented to the bankruptcy judge indicated that Aweco was most likely to suffer a devastating loss were its litigation with United to proceed. The evidence demonstrated that Aweco faced potential liability to United of $17,000,000 and expected to be subject to a judgment exceeding $10,000,000. App. B-5; C-3. Such potential liability would ruin Aweco. App. B-6. Aweco had already spent $720,000 in legal fees during the litigation and could expect to spend $200,000 to $250,000 more through the trial of the case. App. A-4; B-5; C-2. An additional

[5]Although Respondent IRS objected to and argued against approval of the settlement, it offered no evidence to the bankruptcy court in support of its contentions.

factor favoring the settlement was that the net operating loss carryback of approximately $5,300,000 generated by the settlement would substantially reduce the IRS' claim. App. C-3. In addition, the Examiner estimated that after the proposed settlement, Aweco would retain substantial assets. App. C-3.

The bankruptcy court had before it in evidence the contracts that were the subject matter of the lawsuit between Aweco and United; United's Second Amended Complaint that dramatically increased the potential damages; the analysis of damages suffered by United as prepared by outside independent experts; and Aweco's Answer to the Second Amended Complaint. In addition to this documentary evidence, there was testimony appraising the likelihood of a successful outcome for Aweco in the litigation, and outlining the complexity, probable expense and duration of the litigation and indicating the consequent effects on Aweco should a trial take place in Rome, Georgia. App. B-3; C-1-2.

Moreover, the bankruptcy judge, who had presided over the Chapter 11 case for fourteen months since its inception, was totally familiar with the bankruptcy case having received continuous reports from the Examiner. App. B-3. Also, at the December 30, 1981, hearing, counsel for the Creditors' Committee advised the Court that he had analyzed the settlement on behalf of the Creditors' Committee and that Aweco's real exposure in the litigation with United was in the range of $10,000,000 to $17,000,000. App. B-5; C-3. Based on the evidence presented to him, the bankruptcy judge denied the motion for rehearing and reaffirmed his prior order.

The IRS and DOE appealed to the United States District Court for the Northern District of Texas. App. B-1. On September 14, 1982, the district court entered judgment dismissing the

government's appeal and affirming the bankruptcy court's approval of the settlement. App. B-1. The district court's Memorandum Opinion and Order comprehensively reviewed all legal issues and made detailed calculations demonstrating that the settlement was advantageous to Aweco and was in the best interests of creditors. App. B-1.

On November 10, 1982, the IRS filed its notice of appeal to the court of appeals.[6] On February 21, 1984, the panel issued its opinion vacating the judgment below and remanding the case for further proceedings. App. A-1. On April 23, 1984, the court of appeals denied petitioners' timely filed petitions for rehearing and suggestions for rehearing *en banc*. App. E-1. On May 8, 1984, the court of appeals stayed the issuance of the mandate in this case up to and including June 7, 1984, pending application to this Court for a writ of certiorari.

ARGUMENT

I.

THE COURT OF APPEALS ERRONEOUSLY DECIDED IMPORTANT ISSUES UNDER THE NEW FEDERAL BANKRUPTCY CODE THAT SHOULD BE DECIDED BY THIS COURT

A.

Application of the "Absolute Priority" Rule Developed Under Chapter X of the Repealed Bankruptcy Act to Preconfirmation Compromises Under Chapter 11 of the New Bankruptcy Code Conflicts With Congress' Intent and Will Impede Reorganizations

In *In re Aweco, Inc.*, 725 F.2d 293 (5th Cir. 1984), the United States Court of Appeals for the Fifth Circuit held:

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[6]The DOE elected not to appeal.

> Our understanding of bankruptcy law's underlying policies leads us to make a limited extension of the fair and equitable standard: a bankruptcy court abuses its discretion in approving a settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors.

Id. at 298. The court of appeals also noted that "the words 'fair and equitable' are terms of art — they mean that 'senior interests are entitled to full priority over junior ones.' " *Id.*

The fair and equitable standard and the absolute priority rule that is its corollary were developed in connection with corporate reorganizations under Chapter X of the Bankruptcy Act of 1898, as amended (the "Bankruptcy Act"), which was repealed by the Bankruptcy Reform Act of 1978 (the "Bankruptcy Code").[7] In Chapter X no plan of reorganization could be confirmed unless the court found the plan to be "fair and equitable." Section 221(2) of the Bankruptcy Act; 11 U.S.C. § 621(2) (1976) (repealed effective Oct. 1, 1979). As announced by this Court, in order for a Chapter X plan of reorganization to be fair and equitable, the plan had to provide full satisfaction of senior debt or interests before junior debt or interests could receive any satisfaction under the plan.[8] For example, a plan of reorganization which provided ninety percent payment to general unsecured creditors could provide no return to subordinated debenture holders or any holder of an equity

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[7]Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 401(a), 92 Stat. 2549, 2682 (1978).

[8]*SEC v. United States Realty & Improvement Co.*, 310 U.S. 434, 452 (1940); *Protective Committee v. Anderson*, 390 U.S. 414, 441 (1968). *See generally* 6A *Collier on Bankruptcy* ¶¶ 11.02-11.07 (14th ed. 1977).

security. This was so even if the senior class overwhelmingly accepted the plan of reorganization.[9]

To determine whether the full value of the debtor was being properly utilized to satisfy prepetition debt and equity in the plan of reorganization, a complex valuation process had to be complied with by the Chapter X court. In essence, this valuation process required a determination of the going concern value of the debtor based upon capitalized projected earnings, assuming a normal economic climate and adequate capitalization of the debtor.[10]

During the last years the former Bankruptcy Act was in effect, more and more filings occurred under Chapter XI to avoid the onerous requirements and burdens of economic forecasting by experts necessary under the absolute priority rule of Chapter X. As a result, it became one of the principal purposes of Congress in enacting Chapter 11 of the Bankruptcy Code to dispense with the absolute priority rule and the requirement of complex valuation hearings.[11] Thus, under the Bankruptcy Code, as

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[9]*Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 114 (1939) (arising under former § 77B; § 77B was the immediate predecessor of Chapter X) ("where a plan is not fair and equitable as a matter of law it cannot be approved by the court even though the percentage of the various classes . . . required . . . for confirmation of the plan has consented"); *Protective Committee v. Anderson*, 390 U.S. at 435.

[10]*Protective Committee v. Anderson*, 390 U.S. at 442; *Consolidated Rock Prods. Co. v. DuBois*, 312 U.S. 510, 526 (1941) (arising under former § 77B). *See* 6A *Collier on Bankruptcy* ¶¶ 10.13, 11.05 (14th ed. 1977).

[11]That this was the intent of Congress is evident throughout the legislative history:

> Chapter X was designed for a thorough financial reorganization of a corporation. It contemplates very rigid and formalized procedures, and the imposition of strict financial rules governing a plan or [sic] reorganization; which, though designed to protect public creditors, have often worked to the detriment of not only the public creditors, but also the public shareholders and private creditors as well. The negative results under

enacted by Congress, the fair and equitable standard, including the absolute priority rule, applies only to confirmations of plans of reorganization under section 1129(b). 11 U.S.C. § 1129(b) (1982).

Section 1129(b) of the Bankruptcy Code is a device that may be used by a plan proponent. It applies only in the event that the proponent of a plan of reorganization seeks confirmation of that plan when one or more classes of creditors fails to accept the plan of reorganization.[12] In the event that all classes of creditors accept

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Chapter X have resulted from the stilted procedures under which . . . the court values the business, a time consuming and inherently uncertain process.

H.R. Rep. No. 595, 95th Cong., 1st Sess. at 221-22 (1977), *reprinted in* 1978 U.S. Code Cong. & Ad. News 5963 (hereinafter cited as H.R. Rep. at _____). Elsewhere the House Report further details the inadequacies of Chapter X and the need for a different reorganization procedure. "Application of the absolute priority rule under Chapter X has more recently led to the exclusion rather than the protection of the public." *Id.* at 222. "Chapter X has become an unworkable procedure, and Chapter XI is inadequate to fill the void." *Id.* at 223. "The consolidated chapter [Chapter 11] . . . incorporates much of the flexibility of Chapter XI of current law, and incorporates the essence of the public protection features of current Chapter X." *Id.* at 224.

[12]Section 1129(b)(1) of the Bankruptcy Code provides:

> Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

11 U.S.C. §1129(b) (1982). The legislative history to section 1129(b) makes clear that section 1129(b) was intended to be an "alternative confirmation standard, . . . called into play *only on the request of the proponent of the plan.*" 124 Cong. Rec. H 11,104 (daily ed. Sept. 28, 1978)(emphasis supplied); 124 Cong. Rec. S 17,420 (daily ed. Oct. 6, 1978)(emphasis supplied).

See generally 5 *Collier on Bankruptcy* ¶ 1129.03 (15th ed. 1983).

the plan of reorganization, confirmation of the plan would occur pursuant to section 1129(a), regardless of compliance with the fair and equitable standard or the absolute priority rule. In other words, unlike former Chapter X, it is possible under Chapter 11 for junior classes to receive return absent full satisfaction of senior classes, provided confirmation occurs under section 1129(a).[13]

The opinion of the court of appeals in this case erroneously grafts the fair and equitable standard and the absolute priority rule onto pre-plan-of-reorganization compromises and settlements. By so doing, the opinion of the court of appeals totally frustrates Congress' intent to limit application of the fair and equitable standard, the absolute priority rule, and the

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[13]Section 1129(a)(7) provides that a plan may be confirmed if creditors receive property that is not less than what they would receive if the case were liquidated under Chapter 7. Section 1129(b) only applies if a class whose claims or interests are impaired does not accept the plan as required by section 1129(a)(8). The implication of the opinion of the court of appeals is that the fair and equitable rule must be complied with before and even in any plan of reorganization, regardless of whether confirmation of the plan occurs pursuant to section 1129(a) or section 1129(b). The court of appeals stated:

> If a court approves a settlement as part of a reorganization plan absent reasonable assurance that the settlement accords with the fair and equitable standard, the court has abused its discretion . . . .
>
> . . . .
>
> Moreover, if the standard had *no* application before confirmation of a reorganization plan, then bankruptcy courts would have the discretion to favor junior classes of creditors so long as the approval of the settlement came before the plan.

725 F.2d at 298 (emphasis in original). Clearly Congress did not intend that the fair and equitable standard apply to all plans of reorganization, as evidenced by its explicit drafting of sections 1129(a) and 1129(b) of the Bankruptcy Code. *See* note 12, *supra* at 9. Similarly, it is unreasonable to provide a *higher* standard for compromises entered into prior to a plan of reorganization than for compromises embodied in a plan of reorganization ultimately confirmed under section 1129(a) of the Bankruptcy Code.

unnecessary attendant burdens.[14] This Court should, therefore, grant the writ of certiorari and reverse the judgment of the court of appeals to prevent the frustration of Congress' intent and to preserve the rehabilitative aspect of Chapter 11 of the Bankruptcy Code.

B.

The Value Standard Used by the Court of Appeals is Inconsistent with the Intent of Congress and with the Absolute Priority Rule

The opinion of the court of appeals suggests that the proper standard for determining whether a compromise is fair and equitable, and thus consistent with the requirements of the absolute priority rule, is to measure the treatment of the settling creditor and the objecting creditor against liquidation values. This is simply inconsistent with the fair and equitable standard and the absolute priority rule as propounded by this Court under Chapter X of the Bankruptcy Act. The valuation system to be used in determining compliance with the fair and equitable standard and the absolute priority rule is a valuation based on going concern value.[15]

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[14]The legislative history indicates that the intent of Congress in enacting section 1129(b) was to permit senior classes to receive less than full satisfaction of their claims:

> [U]nlike the fair and equitable rule contained in Chapter X and section 77(b) of the Bankruptcy Act under section 1129(b)(2), senior accepting classes are permitted to give up value to junior classes as long as no dissenting intervening classes receives [sic] less than the amount of its claims in full.

124 Cong. Rec. H 11,104 (daily ed. Sept. 28, 1978); 124 Cong. Rec. S 17,420 (daily ed. Oct. 6, 1978).
See also 5 *Collier on Bankruptcy* ¶ 1129.03 (15th ed. 1983).

[15]*Protective Committee v. Anderson*, 390 U.S. at 444; *Consolidated Rock Prods. Co. v. DuBois*, 312 U.S. at 526. *See generally* 5 *Collier on Bankruptcy* ¶ 1125.03 (15th ed. 1983); 6A *Collier on Bankruptcy* ¶¶ 10.13, 11.05 (14th ed. 1977).

Moreover, in addition to being inconsistent with the absolute priority rule as it existed under Chapter X, testing compromise and settlement agreements against liquidation values is inconsistent with the rehabilitative aspect of Chapter 11. For example, such a test would hobble the ability of a service business with a weak balance sheet to reorganize. Even if such a service business could demonstrate a substantial earning capacity, if a proposed compromise would cause deterioration in a senior creditor's position in liquidation, according to the court of appeals, it would be an abuse of discretion for the bankruptcy court to approve the compromise.

Furthermore, even if the court of appeals had applied the valuation standards applicable under the absolute priority rule as it existed under Chapter X, Congress in the Bankruptcy Code specifically rejected the old Chapter X requirement that a bankruptcy court engage in a determination of the going concern value of a debtor other than in connection with confirmation of a plan pursuant to section 1129(b). Section 1125 of the Bankruptcy Code, 11 U.S.C. §1125 (1982), makes clear that such a valuation is ordinarily not required.[16] Indeed, this was one of the major changes in the new law intended by Congress to streamline and improve the rehabilitation process.[17] This Court,

[16]11 U.S.C. §1125(b) (1982) provides: "[t]he court may approve a disclosure statement without a valuation of the debtor or an appraisal of the debtor's assets."

[17][T]he application of that [absolute priority] rule requires a full going concern valuation of the business. Though valuation is theoretically a precise method of determining the creditors' and stockholders' rights in a business, more often the uncertainty of predicting the future, required in any valuation, is a method of fudging a result that will support the plan that has been proposed. As Peter Coogan has aptly noted, such a valuation is usually 'a guess compounded by an estimate.' In a reorganization where time is of the essence, the length and uncertainty of the valuation process is no longer justified in every case.

H.R. Rep. at 222. *See also* 5 *Collier on Bankrupicy* ¶ 1125.03[4] (15th ed. 1983).

therefore, should reverse the judgment of the court of appeals to ensure the improved reorganization process envisioned by Congress when it enacted the Bankruptcy Code.

C.

The Opinion of the Court of Appeals Will Seriously Hinder the Reorganization Process

Of equal concern is the limitation that the opinion of the court of appeals will place upon the ability of a bankruptcy court to approve compromise and settlement agreements. The ability to compromise and settle claims during the pendency of a Chapter 11 ease is a significant power exercisable by a debtor with court approval. The new Bankruptcy Rule 9019, which supersedes former Bankruptcy Rule 919, makes this clear. Under Rule 9019(b) a court may authorize a debtor to effect seriatim compromises of similar controversies: i.e., to settle with classes of creditors outside a plan of reorganization.

The opinion of the court of appeals in this case leaves substantial doubt concerning the ability of a court to authorize compromise under Rule 9019 of a single controversy, much less a series of them, absent extensive and expensive proceedings concerning valuation. The court of appeals quotes with approval *In re Boston & Providence R.R. Corp.*, 673 F.2d 11 (1st Cir. 1982), another case arising under the repealed Bankruptcy Act. In that ease the First Circuit noted that a reorganization court should, *sua sponte*, determine that a compromise is fair and equitable. It is a logical — even inescapable — conclusion that the opinion of the court of appeals in this case must be read, if not to require a reorganization court to apply *sua sponte* the absolute priority rule, at least to allow any member of a class to interpose an objection to settlement of any dispute with another member of that class or a member of an inferior class unless such settlement

complies with the fair and equitable standard and the absolute priority rule, as enunciated by the court of appeals: that the debtor must prove beyond doubt that such proposed settlement would not detract from the treatment which would be given the objecting creditor in liquidation. Thus, even though the vast majority of a class of creditors might favor a given compromise and settlement, a single member of that class could effectively blackmail the debtor and the creditor's classmates by slowing or even stopping the reorganization process through repeated objections to proposed settlements.

Furthermore, the decision of the court of appeals will encourage settlement of controversies under cover of other types of action. In a Chapter 11 case much of what a debtor does involves dealing with creditors and prepetition claims. Often a prepetition dispute may be settled in the context of assumption of a lease, collective bargaining agreement or other contract, allowance of a secured position, entry into an agreed order authorizing use of cash collateral, or otherwise. The opinion of the court of appeals leads to the absurd result that a compromise and settlement agreement with a landlord owed substantial prepetition rent or a union whose members are owed wages and benefits is not subject to the absolute priority rule if the settlement is dubbed the assumption of a lease or contract but would be subject to the absolute priority rule if called a Rule 9019 compromise or settlement. Alternatively, it would seriously interfere with bankruptcy administration if each and every action by a debtor taken with court approval, which might involve satisfaction of prepetition debt, would have to comply with the absolute priority rule.

Were the latter the case, no lease, collective bargaining agreement or other contract could be assumed after the commencement of the case without satisfaction of the valuation standards set by section 1129(b). No cash collateral agreement or

financing agreement that in any way enhanced a creditor's prepetition position could be approved by a bankruptcy court, no matter how critical to the continued operation of the debtor, without first requiring a complex valuation hearing identical to that which made Chapter X of the repealed Bankruptcy Act so unworkable. In the case of the reorganization of a multinational corporation, operations outside of the United States would be irretrievably crippled by the inability of the debtor to enter into settlements with foreign creditors.

The doctrine enunciated by the court of appeals applies on its face to all post-petition actions by a debtor. Thus, if a debtor cannot affirmatively show that a proposed action will not adversely affect the position of a creditor in liquidation, then the action cannot be permitted. This creates a catch-22: in order to prove value, expert testimony is required; experts are entitled to payment ahead of all prepetition unsecured and priority claims; [18] therefore, experts should not be hired unless it can be shown that the proposed hiring will not adversely affect the position of a prepetition creditor in liquidation.

It is important, therefore, to the proper administration of cases by the bankruptcy courts that this Court grant the writ herein prayed for and, ultimately, reverse the judgment of the court of appeals.

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[18]Pursuant to 11 U.S.C. §327 (1982), the trustee or debtor-in-possession may, with court approval, employ professional persons, including appraisers. Fees of appraisers are allowable under section 503(b) of the Bankruptcy Code as administrative expenses entitled to priority under section 507(a). *See generally* 11 U.S.C. §§503(b), 507(a) (1982).

D.

The Bankruptcy Code Provides Specifically For Protection of Senior Creditors By Means Other Than Application of the Absolute Priority Rule

The Bankruptcy Code was not a statute drafted solely to protect debtors.[19] Rather, Congress specifically provided Chapter 11 creditors (including Respondent) with the ability to file a plan of reorganization,[20] to move to dismiss a case or to convert a case to Chapter 7 liquidation,[21] or to seek the appointment of a trustee.[22] In addition, Congress provided that a Chapter 11 debtor could not affect the rights of certain persons without providing them "adequate protection."[23] Adequate protection, however, has been found to run only to secured creditors or persons asserting an ownership interest in assets held by a debtor.[24]

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[19]The House Report indicates that while revision of the Bankruptcy Act was necessary for providing a more effective remedy for debtors, "[t]his [bill] is not primarily a debtor's bill, however. The bill codifies creditors' rights more clearly than the case law, which is in many ways just developing. It defines the protections to which a secured creditor is entitled, and the means through which the court may grant that protection." H.R. Rep. at 4-5.

[20]11 U.S.C. § 1121(c) (1982).

[21]11 U.S.C. § 1112(b) (1982).

[22]11 U.S.C. § 1104 (1982).

[23]Adequate protection may be simply stated to be protection against deterioration in position. *See* 11 U.S.C. §§ 361-364 (1982). *See also* H.R. Rep. at 182-83 ("The provisions governing the right of the trustee or debtor-in-possession to use, sell or lease soft collateral also require that the secured creditor's interest be adequately protected").

[24]*In re Garland Corp.*, 6 Bankr. 456 (Bankr. D. Mass. 1980); *In re Southern Biotech, Inc.*, 37 Bankr. 318 (Bankr. M.D. Fla. 1983). *See* H.R. Rep. at 338-339.

Congress was no doubt aware that the statute was drafted such that adequate protection could be afforded only to secured creditors.[25] Congress did not provide priority creditors that same adequate protection. Rather, Congress determined that priority unsecured creditors should stand on the same footing as general unsecured creditors. The court of appeals erroneously ignored the intent of Congress and judicially granted to priority creditors a status not provided to them by the Bankruptcy Code.

All creditors have substantial protection against capricious actions by a debtor. As in the instant case, notice will be given and hearing had concerning settlement of a dispute in a Chapter 11 case. A bankruptcy judge will not approve a settlement not in the best interests of creditors over vigorous objection, but neither should the judge nor the debtor be constrained by application of the outmoded and outlawed absolute priority rule.

If a creditor, including a priority creditor, believes a debtor is not acting in the best interest of creditors in settling claims, that creditor has a host of remedies. It may seek appointment of a trustee, conversion to Chapter 7 or dismissal of the case. It may seek to limit the authority of a Chapter 11 debtor.[26] Until a plan is filed and reaches a hearing on confirmation, however, there is no provision in the Bankruptcy Code suggesting that the limited application of the fair and equitable standard of section 1129(b) may be used to hinder a debtor in the administration of the case and the conduct of its business. This Court, therefore, should grant the writ of certiorari and reverse the judgment of the court

[25]The legislative history indicates that the concept of adequate protection is "derived from the fifth amendment protection of property interests," and goes on to state that "secured creditors should not be deprived of the benefit of their bargain." H.R. Rep. at 339.

[26]11 U.S.C. §§ 1107, 1108 (1982).

of appeals to ensure that the fair and equitable standard is applied in the limited manner intended by Congress in the Bankruptcy Code.

II.

THE STANDARD APPLIED BY THE COURT OF APPEALS FOR THE APPROVAL OF A COMPROMISE AND SETTLEMENT AGREEMENT CONFLICTS WITH THE STANDARD FIXED BY THIS COURT IN *PROTECTIVE COMMITTEE V. ANDERSON*, 390 U.S. 414 (1968), AND ADOPTED BY THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT IN *IN RE FLIGHT TRANSPORTATION CORPORATION SECURITIES LITIGATION*, 730 F.2d 1128 (8th Cir. 1984)

In *Protective Committee v. Anderson*, 390 U.S. 414 (1968), this Court stated that no determination could be made as to whether a compromise and settlement agreement should be approved until:

> [T]he bankruptcy judge has apprised himself of all facts necessary for an intelligent and objective opinion of the probabilities of ultimate success should the claim be litigated. Further, the judge should form an educated estimate of the complexity, expense, and likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise.

390 U.S. at 424. This standard is essentially the standard set out in *Drexel v. Loomis*, 35 F.2d 800, 806 (8th Cir. 1929).[27]

This standard has been adopted any number of times in regard to approval of compromise and settlement agreements. The former Fifth Circuit, in fact, adopted a similar standard in the companion cases *In re Jackson Brewing Co.*, 624 F.2d 599, 602 (5th Cir. 1980) and *In re Jackson Brewing Co.*, 624 F.2d 605, 609 (5th Cir. 1980). This standard was applied consistently in Chapter X and XI cases under section 27 of the Bankruptcy Act, 11 U.S.C. § 50 (1976) (repealed effective Oct. 1, 1979). In *In re Flight Transp. Corp. Securities Litigation*, 730 F.2d 1128, 1135 (8th Cir. 1984), the court specifically adopted this standard in regard to a settlement in a liquidating Chapter 11 case. In that case, the settlement involved division of escrowed funds among subordinatable creditors and senior debt holders prior to payment in full of that senior debt.

Petitioners have found *no* authority, and the court of appeals opinion cites none, applying the Chapter X absolute priority rule to preconfirmation settlements and compromises in bankruptcy cases under Bankruptcy Rules 919 or 9019 and Chapter 11 of the new Bankruptcy Code.[28] Instead, *every* case found by Petitioners

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[27]Respondent suggested below that *In re Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983), and *In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983), supply the proper standard for testing the compromise in the instant case. Those cases involved sales of such importance to the reorganizations that the courts determined that approval of the sales should be conditioned upon observing the safeguards (*e.g.*, in 11 U.S.C. § 1125 (1982)) applicable to plans of reorganization. The lower court apparently felt that standard inappropriate in this case, since it did not apply that standard. *Cf. In re Flight Transp. Corp. Securities Litigation*, 730 F.2d 1128 (8th Cir. 1984).

[28]Petitioners have researched the following words or phrases through Lexis and Westlaw: "fair and equitable and absolute priority"; "fair and equitable and 919 or 9019"; and "fair and equitable and section 27." These searches identified a total of 359 reported cases. The court of appeals decision in this case is the *only* case Petitioners have found that applies the absolute priority rule to compromise and settlement agreements outside of a plan of reorganization.

involving approval of settlements and compromises under prior law and Chapter 11 of the new Bankruptcy Code adopts the principles of *Protective Committee v. Anderson* as set out above, section 27 of the Bankruptcy Act, and Bankruptcy Rules 919(a) and 9019(a). These general principles are described in *Protective Committee v. Anderson, Drexel v. Loomis,* and *Florida Trailer & Equipment Co. v. Deal,* 284 F.2d 567, 571, 573 (5th Cir. 1960), which held that under section 27 a bankruptcy court must determine (i) the probability of success in the litigation, with due consideration for (ii) the uncertainty in fact and law, (iii) the complexity and likely duration of the litigation, and (iv) the attendant expense, inconvenience and delay that could result from continuance of the litigation. *Accord In re General Store of Beverly Hills,* 11 Bankr. 539, 541 (Bankr. 9th Cir. 1981); *In re Salem Mortgage Co.,* 34 Bankr. 902, 909 (Bankr. E.D. Mich. 1983); *In re Sherman Homes, Inc.,* 28 Bankr. 176, 177 (Bankr. D. Me. 1983); *In re Oceanside Properties, Inc.,* 14 Bankr. 95, 99 (Bankr. D. Hawaii 1981). The orders of the bankruptcy court and the district court in this case explicitly and faithfully conform to the applicable legal standard.

The court of appeals overlooks that *Protective Committee v. Anderson* was a case with two foci. In that Chapter X proceeding, a plan of reorganization had been approved at the trial court level that (i) adopted certain compromises and settlements involving secured and unsecured claims by insiders against the debtor; and (ii) eliminated the interest of shareholders on the basis that the value of the company was insufficient to provide for shareholder participation given the absolute priority rule. *It was the shareholders of the debtor who sought review* in this Court, and the effect of the decision in *Protective Committee v. Anderson* was *not* to provide protection to senior creditors against compromise of junior debt, but rather to provide (i) that full and complete review in accordance with the standards set out above be given to the compromise and settlement agreements with insiders and

(ii) that the valuation of the debtor be redone to ensure that shareholders would not be improperly eliminated from participation in the reorganized debtor.

Protective Committee v. Anderson provides no support even under old Chapter X for the position of the court of appeals, that a settlement which is not part of a plan of reorganization must be tested by the absolute priority rule and the valuation standards applicable when the absolute priority rule controls. Rather, *Protective Committee v. Anderson* applies the precise four-part test for settlements and compromises applied by the bankruptcy court and the district court in this case and rejected by the court of appeals.

It is critical that this Court provide guidance to the lower courts for determining when, if ever, the absolute priority rule should be applied in the course of the administration of a Chapter 11 case. Although the decision by the court of appeals is the only case on record in which the absolute priority rule has ever been applied to a preconfirmation compromise and settlement, the court of appeals and the United States Court of Appeals for the Eighth Circuit in *In re Flight Transp. Corp. Securities Litigation are the highest courts to rule under present Chapter 11 regarding the standard to be applied to compromise and settlement agreements.* Thus, even outside of the fifth circuit, in which the decision of the court of appeals is binding, great deference can be expected to be shown to the opinion of the court of appeals notwithstanding this Court's prior holding in *Protective Committee v. Anderson* and the opinion of the United States Court of Appeals for the Eighth Circuit in *In re Flight Transp. Corp. Securities Litigation.*

CONCLUSION

The court of appeals erred in this case by applying the absolute priority rule developed under Chapter X of the repealed Bankruptcy Act to a preconfirmation compromise and

settlement in a bankruptcy case under Chapter 11 of the new Bankruptcy Code. That decision frustrates Congress' intent by seriously hindering the reorganization process envisioned by Congress when it enacted the Bankruptcy Code. In addition, the decision of the court of appeals directly conflicts with this Court's prior opinion in *Protective Committee v. Anderson* and the opinion of the United States Court of Appeals for the Eighth Circuit in *In re Flight Transp. Corp. Securities Litigation.*

Because this case both presents an important question of federal law and conflicts with applicable precedent of this Court, Petitioners Aweco, Inc. and United-American Car Co. pray that this Court will grant their petition for a writ of certiorari, will reverse the judgment of the United States Court of Appeals for the Fifth Circuit, and will remand this action to the court of appeals to determine whether the compromise and settlement at issue was properly approved under the four-part standard adopted by this court in *Protective Committee v. Anderson.*

Respectfully submitted,

Frank C. Jones
Walter W. Driver, Jr.
James A. Pardo, Jr.
KING & SPALDING
2500 Trust Company Tower
Atlanta, Georgia 30303
(404) 572-4600

ATTORNEYS FOR
PETITIONER
UNITED-AMERICAN
CAR CO.

D. M. Lynn
Stuart M. Reynolds, Jr.
MOORE & PETERSON
A Professional Corporation
2800 First City Center
Dallas, Texas 75201-4621
(214) 754-4800

MAHON & WINSTON
2430 One Main Place
Dallas, Texas 75250

ATTORNEYS FOR
PETITIONER
AWECO, INC.

APPENDICES

APPENDIX A

In the Matter of AWECO, INC., Debtor.

UNITED STATES of America, (Internal Revenue Service and Department of Energy), Plaintiffs-Appellants,

v.

AWECO, INC., Debtor-Appellee,

and

United American Car Company, Appellee.

No. 82-1621

United States Court of Appeals, Fifth Circuit

Feb. 21, 1984.

Appeal from the United States District Court for the Northern District of Texas.

Before GOLDBERG, GEE and TATE, Circuit Judges.

GOLDBERG, Circuit Judge:

In this case principles of fairness and equity surface to point to the right result, even as we move through a field of law as narrow and arcane as bankruptcy. Bankruptcy decisions are often judgmental, but, they are factually oriented. In settling a lawsuit, the debtor in this case acted with the approval of the bankruptcy court, and disbursed a very significant portion of its estate to one of its unsecured, nonpriority creditors. The district court affirmed the action of the bankruptcy court. The government, as a priority creditor, claims that the bankruptcy

court approved the settlement without sufficient facts to determine the payout's fairness to the government. We agree and vacate the district court's affirmance, remanding for the taking of further evidence on the settlement's fairness.

I. BACKGROUND

This appeal involves three parties: AWECO, Inc., United American Car Co. ("United") and the United States. Debtor, AWECO, is engaged in various ventures, primarily in the oil and gas business. In early 1981, AWECO filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code.[1] AWECO filed a plan of reorganization several months later, but, the plan was never presented to creditors for approval nor submitted to the court for confirmation. Four of AWECO's creditors, the Department of Energy, the IRS, Sutton Investments, Inc. ("Sutton") and United,[2] have at one time or another been involved in these proceedings. The Department of Energy holds an unsecured claim for $45,000,000 based on its determination that AWECO overcharged its customers for certain crude oil the company sold. The IRS has two priority tax claims,[3] one from 1979 in the amount of $4,088,718.08, and one from 1980 in the amount of $2,058,495.50. Sutton's claim is for $7,577,584.98 and is secured by a judgment lien on certain of AWECO's assets.

United's claim, the settlement of which produced the instant appeal, is an unsecured, unliquidated claim for approximately $27 million. This claim, asserted in a lawsuit in the United States District Court for the Northern District of Georgia, stems from

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[1] 11 U.S.C. § 1101 et seq.

[2] The debtor's schedules list 27 claims against it.

[3] On appeal an unresolved dispute remains as to whether the larger of the tax claims is secured. Both of the claims, however, have priority status under 11 U.S.C. § 507(a)(6).

two contracts between United and AWECO. In these contracts, AWECO agreed to purchase approximately $40 million worth of railroad cars from United. AWECO refused to perform and United sued for breach of contract. United later amended its complaint to include allegations of fraud, asserting the $27 million damage figure.[4] After two years of litigation and while AWECO's Chapter 11 petition was pending, United and AWECO reached a negotiated settlement of the lawsuit. The settlement called for the transfer from AWECO to United of some $5.3 million worth of cash and property. The assets to be transferred included property that secured the Sutton claim, and according to the IRS, secured the larger of its tax claims.

In early November of 1981, AWECO filed notice with the bankruptcy court of its intention to settle the litigation. The Department of Energy, the IRS, Sutton and the Creditors' Committee all filed objections to the proposed settlement. The bankruptcy court held a hearing on December 30, 1981, to consider the objections. At the outset of the hearing, the Creditors' Committee withdrew its objections, but the Department of Energy, the IRS and Sutton[5] continued their opposition to the settlement. The court heard testimony from four witnesses: AWECO's president, the court-appointed examiner, the debtor's comptroller and accountant, and an attorney representing United in the Georgia litigation with AWECO.

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[4]Specifically, United asserted that AWECO falsely represented that it, AWECO, had completed construction of an oil refinery in Lake Charles, Louisiana, and that the refinery showed an annual operating profit of $50 million. Further, the amended complaint alleged that debtor misused corporate funds to benefit the family of the company's president and that AWECO failed to disclose that the company's chairman of the board had been convicted in 1977 of defrauding the First National Bank of Chicago.

[5]Sutton's objection was conditional. The company's concern centered on the displacement of its lien on certain of AWECO's property. Sutton indicated its willingness to withdraw the objection if the court granted it a replacement

Part of the testimony focused on the fairness of the settlement as between United and AWECO. United's counsel testified regarding the reasons United was willing to accept $5.3 million on its claim of $27 million. By reselling the railroad cars, United had been able to recoup enough of its losses to reduce the claim to $17.4 million. In addition, United wished to avoid the delay, risk and expense involved in further litigation. Even if it prevailed in the suit, United had no guarantee that it would receive as much as $5.3 million as an unsecured creditor in bankruptcy proceedings. And, United wanted to settle the case so that it could count the settlement proceeds in its 1981 taxable year. The settlement was, in fact, conditioned upon the bankruptcy court's immediate approval.

Other testimony evidenced the advantages to AWECO of the settlement. The AWECO attorney involved in the Georgia litigation stated that terminating the litigation would save an estimated $200,000-250,000 in legal expenses of trying the suit; the two years of previous litigation had cost AWECO over $700,000. He also testified as to the weakness of AWECO's primary defense to the suit. AWECO's comptroller declared that the settlement would generate a loss for the company that would carry back to offset $2-2.5 million of tax liability.

Most of the remaining testimony centered on the settlement's fairness to creditors other than United. A significant part of that testimony concerned AWECO's interest in a nonoperating oil refinery in Lake Charles, Louisiana. Previous managers had been unable to operate the refinery at a profit. AWECO's president declared that despite the refinery's history and currently

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lien on substituted property of a comparable value. In a December 31, 1981, order the court granted Sutton a replacement lien on "properties of the Debtor not required for and remaining after consummation of the settlement, including, without limitation, real estate, personal property, contract rights, notes and accounts receivable, interest in subsidiaries and joint ventures, and any other assets as to which said lien claimants previously had no lien claim."

deteriorating conditions, AWECO's control of the refinery would lead to profits. He also noted that the Lake Charles refinery formed the basis for a successful reorganization plan. The court-appointed examiner testified as to the refinery's liquidation value, estimating it at $13 million.[6] He admitted that he did not know whether the refinery was encumbered by prior liens. The examiner attributed his lack of knowledge regarding the existence of prior liens to his lack of direct control over the refinery. Counting the $13 million from the refinery, the examiner estimated that the proposed settlement would leave $30 million in the estate. His testimony on specific assets, however, listed properties including the refinery that totaled only $17.5 million in value.

At the close of the hearing the bankruptcy court announced it would approve the settlement. On the following day the court issued a written order, finding the settlement "fair and equitable" and "in the best interests of the Debtor, its estate, and its creditors." The court allowed a payment of $1 million to United after ten days and ordered that the final consummation of the settlement take place within a month.

The IRS and Department of Energy sought a rehearing. The judge then agreed to hear more testimony, citing doubts concerning the liquidation value of the refinery. Record, Vol. II, pp. 4-5. At the subsequent hearing, AWECO's president estimated that the entire refinery was worth $22 million — that AWECO's 56⅔% interest would yield the company from $13 to 14 million.[7] The president arrived at the $22 million figure from

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[6]The examiner, an accountant, admitted that he had no experience at estimating liquidation values and that he had no special knowledge concerning oil refineries.

[7]The $13-14 million figure assumes that AWECO receives a certain amount as a return of capital before a split of the other sales proceeds.

his participation in sales discussions regarding the refinery. He testified, though, that no offer had been made and $22 million had only been "mentioned." In contrast to his testimony at the initial hearing, he stated that AWECO had no plans to operate the refinery. He declared that the facility would be sold.

Government counsel moved for a continuance to develop evidence with respect to the value of the refinery, but the court denied the motion. The court was only willing to grant a government request to submit an appraisal of the facility subsequent to the hearing if United would extend its time limit on confirmation of the settlement. When counsel for United stated that any stay of the court's order approving the settlement would jeopardize the deal, the court denied a stay.

II. APPEAL

The IRS and Department of Energy then appealed to the district court. Their arguments centered on the settlement's fairness to creditors other than United rather than any doubts regarding fairness between AWECO and United. Rejecting these arguments, the district court affirmed the lower decision. The district judge relied on the fact that the bankruptcy court had taken testimony on the settlement's fairness to creditors. He also cited the bankruptcy judge's knowledge of the case derived from months of presiding over the reorganization proceedings. The district judge concluded that, because testimony at the earlier hearings indicated that a settlement with United would give the debtor its only chance at reorganization, the settlement benefitted all creditors.

The IRS now brings this appeal. It asserts that the bankruptcy court abused its discretion in approving the settlement of the unsecured, unliquidated claim. Arguing that the bankruptcy

court acted on too little information, the government contends that principles of fairness and equity fell victim to the perceived need for speed in approving the settlement.

III. DISCRETION AND THE "FAIR AND EQUITABLE" STANDARD

The bankruptcy court derives its authority to approve settlements from Bankruptcy Rule 919(a). The Rule provides that, "on application by the trustee or receiver and after hearing on notice to the creditors as provided in Rule 203(a) and to such persons as the court may designate, the court may approve a compromise or settlement." 11 U.S.C. Rule 919(a). Compromises may be effected separately during reorganization proceedings or in the body of the reorganization plan itself. 6 (part 2) *Collier on Bankruptcy*, ¶ 807 at 1405 (14th ed. 1978). The decision of whether to approve a particular compromise lies within the discretion of the trial judge; an appellate court will reverse only when that discretion has been abused. *Matter of Jackson Brewing Co.*, 624 F.2d 599, 602-03 (5th Cir. 1980); *see also Matter of Walsh Const.*, 669 F.2d 1325, 1328 (9th Cir. 1982); *Matter of Ocobock*, 608 F.2d 1358, 1360 (10th Cir. 1979); *In re Albert Harris*, 313 F.2d 447, 449 (6th Cir. 1963).

The exercise of judicial discretion always carries with it responsibility.

> The term "discretion denotes the absence of a hard and fast rule (citations omitted). When invoked as a guide to judicial action, it means a sound discretion, that is to say, a discretion exercised not arbitrarily or wilfully, but with regard to what is right and equitable under the circumstances and the law, and directed by the reason and conscience of the judge to a just result.

Langnes v. Greene, 282 U.S. 531, 541, 51 S.Ct. 243, 247, 75 L.Ed. 520 (1931). With regard to approval of compromises that form part of a plan of reorganization, an even more definite rule limits the exercise of discretion. A court may approve such a compromise or settlement only when it is "fair and equitable." *Protective Committee v. Anderson*, 390 U.S. 414, 424, 88 S.Ct. 1157, 1163, 20 L.Ed.2d 1 (1968); *Matter of Jackson Brewing Co., supra*, 624 F.2d at 602. The words "fair and equitable" are terms of art — they mean that "senior interests are entitled to full priority over junior ones." *SEC v. American Trailer Rentals Co.*, 379 U.S. 594, 85 S.Ct. 513, 13 L.Ed.2d 510 (1965); *Protective Committee v. Anderson, supra*, 390 U.S. at 441, 88 S.Ct. at 1171. If a court approves a settlement as part of a reorganization plan absent reasonable assurance that the settlement accords with the fair and equitable standard, that court has abused its discretion.

The facts of this case pose the following question: in the period prior to confirmation of a reorganization plan, must the bankruptcy court apply the fair and equitable standard in considering a priority creditor's objections to a settlement? United argues that the fair and equitable standard should not extend so far, implying that a bankruptcy court should not concern itself with the objection pressed by the government. Citing no authority, United argues that extension of the fair and equitable standard would frustrate the new Bankruptcy Code's policy of "less rigid and formalized procedures." Because classes of claims are not complete in the pre-plan stages of reorganization proceedings, application of the fair and equitable standard would preclude all compromises or settlements prior to a plan of reorganization.

We reject United's argument on two grounds. First, the argument is simply not relevant here. An application of the fair and equitable doctrine in this case does not take us as far as United suggests. The limited question that we face is whether the

holder of an outstanding senior claim[8] can validly object to a proposed settlement with a junior claimant on the basis that the settlement will keep the senior claimant from being paid in full. The answer to this question has no necessary implications beyond the present, limited context.

Second, we find the policy arguments convincing that some extension of the fair and equitable standard is proper. As soon as a debtor files a petition for relief, fair and equitable settlement of creditors' claims becomes a goal of the proceedings. The goal does not suddenly appear during the process of approving a plan of compromise. Moreover, if the standard had *no* application before confirmation of a reorganization plan, then bankruptcy courts would have the discretion to favor junior classes of creditors so long as the approval of the settlement came before the plan. Regardless of when the compromise is approved, looking only to the fairness of the settlement as between the debtor and the settling claimant contravenes a basic notion of fairness. An estate might be wholly depleted in settlement of junior claims — depriving senior creditors of full payment — and still be fair as between the debtor and the settling creditor. Our understanding of bankruptcy law's underlying policies leads us to make a limited extension of the fair and equitable standard: a bankruptcy court abuses its discretion in approving a settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors.

IV. INFORMED DETERMINATIONS

Having ascertained the standard which governs approval of the settlement in this case, we must now decide whether that standard was met. Initially, we note that important

[8]We find no dispute below with regard to the government's filing a proof of claim for approximately $6.1 million.

determinations in reorganization proceedings must receive the "informed, independent judgment of the Bankruptcy Court." *Protective Committee v. Anderson, supra,* 390 U.S. at 424, 88 S.Ct. at 1163. The duty of a bankruptcy judge to reach an "intelligent, objective and educated evaluation" of settlements cannot be carried out absent a sufficient factual background. *Matter of Jackson Brewing Co., supra,* 624 F.2d at 602. This requisite factual background assumes particular importance with respect to determinations hinging on the fair and equitable standard. A decision on whether a settlement with a junior creditor depletes the estate so severely as to endanger senior claims requires full and accurate information about the net value of estate assets.

An examination of the record in the case before us reveals gaping holes in the background of information regarding the United-AWECO settlement. Although the court found that $30 million worth of assets would remain in the estate after the settlement, the examiner's testimony as to specific assets totalled only a little over $17 million. Even with respect to the assets that the examiner specifically named, the information before the bankruptcy court was inadequate. The examiner, who put a $13 million tag on AWECO's interest in the Lake Charles refinery, had no experience in estimating liquidation values and no expertise pertaining to oil refineries. The president's $22 million estimate for the value of the whole refinery rested on an unknown party's "mention" of a figure during negotiations. Most importantly, the examiner admitted that he did not know whether the refinery was encumbered by prior liens. The information contained in the record is so incomplete that any valuation of the refinery alone or of the estate as a whole is purely conjectural. In determining the value of the estate, the court failed to play the appropriate "quasi-inquisitorial role." *Matter of Boston & Providence R. Corp.*, 673 F.2d 11 at 12 (1st Cir. 1982).

Under the facts of this case, which party bears the burden of establishing the estate's value is irrelevant. Even were the burden cast upon the objecting creditor, unsubstantiated, gratuitous declarations regarding an estate's worth cannot support an approval of a settlement. In a railroad reorganization case the First Circuit observed: [In approving compromises] "the court must act independently, out of its own initiative, for the benefit of all creditors. This obligation prevails even where the creditors are silent." *Matter of Boston & Providence R. Corp., supra,* 673 F.2d 11 (1st Cir. 1982); *see also Ashbach v. Kirtley,* 289 F.2d 159, 166 (8th Cir. 1961). We agree. An approval of a compromise, absent a sufficient factual foundation, inherently constitutes an abuse of discretion.

Given the nature of settlements and of this one in particular, it is not difficult to understand the dearth of information. United exerted pressure upon AWECO to gain approval of the settlement quickly, lest United lose the tax advantage that provided part of the settlement's consideration. Time pressure apparently influenced the bankruptcy judge to deny the government's request for a continuance to develop evidence on the refinery's worth and to deny the government leave to submit its own appraisal of the refinery. In an analogous situation in *Protective Committee v. Anderson, supra,* 390 U.S. at 450, 88 S.Ct. at 1176, the Supreme Court voiced its sympathy with the desire of a court to terminate protracted bankruptcy proceedings. However, the Court observed that, "the need for expedition is not a justification for abandoning proper standards." *Id.* We also sympathize with the bankruptcy judge who has suffered the travails of months filled with the problems of the debtor and its creditors. We acknowledge the principle that justice delayed is justice denied. Moreover, preserving a settlement potentially advantageous to the debtor and its creditors is a worthy goal. Nevertheless, the circumstances below, surrounding approval of this settlement, called for a pause. Proof of value must find

expression in definite numbers, not figures merely opined, mentioned or guessed. The bankruptcy judge should not reach for his stamp marked "approved" unless some party supplies concrete facts.

V. CONCLUSION

The terms "equity" and "fairness" are not only terms of art in bankruptcy — they are catch words of bankruptcy law in general. Equitable considerations should be preeminent in the exercise of bankruptcy jurisdiction. *See Bank of Marin v. England*, 385 U.S. 99, 103, 87 S.Ct. 274, 277, 17 L.Ed.2d 197 (1966); *see also Demet v. Harralson*, 399 F.2d 35, 39 (5th Cir. 1968). Furthermore, decisions as central to bankruptcy proceedings as approval of settlements cannot be visceral. They must issue from reason and rest upon factual undergirdings.

In this case time pressure functioned as a shotgun. The bankruptcy court blessed the settlement without sufficient factual information to determine if the settlement was fair and equitable to the government. Our purpose in annulling that blessing is to assure that factually unsupported approvals of settlements do not impose an unfair detriment on creditors; we do not write to radically restrict bankruptcy courts' discretion to approve settlements. Rather, with guidance from today's holding and facts developed from further proceedings we anticipate that the bankruptcy court below can properly exercise its discretion. We therefore vacate the order of the District Court and remand with instructions to return this case to the bankruptcy court for proceedings consistent with this opinion.

VACATED and REMANDED.

APPENDIX B

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

IN RE
AWECO, INC.
DEBTOR

No. CA3-82-0474-F

MEMORANDUM OPINION AND ORDER

This action is an appeal from an Order by the Dallas Bankruptcy Court approving a settlement and compromise of litigation between Aweco, Inc., and United American Car Company (hereinafter called UAC). In the settlement, Appellee Aweco agreed to pay approximately $5.3 million in cash and properties for dismissal of pending litigation in a United States District Court at Rome, Georgia, wherein UAC was Plaintiff and Aweco was Defendant. UAC originally filed a general unsecured claim against Aweco in the approximate amount of $27 million for asserted breach of contract damages incurred from a contract to purchase and manufacture 1,000 railroad cars valued at about $40 million.

On December 30, 1981, the Bankruptcy Court conducted a hearing regarding this settlement and compromise. After receiving additional outside information questioning the reliability of the hearing's evidence, the Court conducted another hearing on February 2, 1982, to acquire additional evidence regarding the settlement. After acceptance of the settlement by the Court two other creditors of Aweco, the Internal Revenue Service (IRS) and the Department of Energy (DOE) objected to and perfected this appeal.

The basis of appeal centers around three main issues: (1) whether the Bankruptcy Court abused its discretion in approving

the compromise settlement; (2) whether Aweco owned sufficient additional equity for displacement of federal tax liens; (3) whether payment under the settlement to UAC, a general unsecured creditor, prior to payment of all other creditors violates the system of priorities established under the Bankruptcy Code. Each argument will be considered separately.

Abuse of Discretion

The scope of review for an order from a bankruptcy court under the 1978 Bankruptcy Reform legislation continues to be a "clearly erroneous" standard. *In re Bleaufontaine, Inc.*, 634 F.2d 1383 (5th Cir. 1981); 1 Collier on Bankruptcy ¶ 3.03(b) (15th ed. 1979). An appellate court may not reverse simply because on the same evidence it may have reached a different result. *In re Multiponics, Inc.*, 622 F.2d 709, 723 (5th Cir. 1980). In applying this standard, this Court must review the basis upon which the bankruptcy judge based his final decision of approval.

An approval of a compromise settlement in a bankruptcy proceeding is governed by the standard set out in *Protective Committee v. Anderson*, 390 U.S. 414 (1968). In *Anderson*, the Supreme Court directed that the litigating hazards of pending litigation must be considered before a Court can approve a settlement:

> There can be no informed and independent judgment as to whether a proposed compromise is fair and equitable until the bankruptcy judge has apprised himself of all the facts necessary for an intelligent and objective opinion of the probabilities of ultimate success should the claim be litigated. Further, the judge should form an educated estimate of the complexity, expense, and likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all the other factors

> relevant to a full and fair assessment of the wisdom of the proposed compromise. Basic to this process in every instance, of course, is a need to compare the terms of the compromise with the likely rewards of the litigation. *Id.* at 424-25.

It appears from the record that in the case at bar the judge did apprise himself of the necessary facts to form an intelligent and objective opinion as to the probable outcome of the litigation in Georgia.

The record includes testimony by Mr. Hargis, the President of Aweco; Mr. Mancuso, the Examiner; Mr. Driver, counsel for the plaintiff in the Georgia litigation; and Ms. Elsaesser, the Aweco controller. Each contributed to the appraisal of the litigation's success, complexity, expense and duration. More revealing than the testimony were the exhibits which were introduced in the pleadings before the Court. These exhibits included the contracts which were the subject matter of the litigation to be compromised, the Second Amended Complaint filed by the Plaintiff, an analysis by an independent accounting firm of the damages suffered by the plaintiff, and Aweco's answer to the Second Amended Complaint. All of these documents gave the judge a valid foundation with which to determine the success of the Georgia litigation.

In addition to the documents and testimony, the Bankruptcy Court also relied on other information. The judge continuously presided over the bankruptcy proceedings for fourteen months. In such capacity, he received regular reports from the Examiner detailing the business and financial affairs of Aweco. Such reports included an account of all funds received, and the status of business and debtor relief proceedings. This additional information also influenced the approval of the compromise.

Appellant's argument that the honorable judge applied the wrong standard in approving the settlement and was relying solely on the request of the debtor and the Creditors Committee is wholly without basis. The *Anderson* standard was complied with. Not only was an evidentiary hearing held on December 30, 1981, to obtain needed facts about the litigation, but another hearing was held on February 1, 1982, to give the judge additional facts upon which to base his recommendation. As the judge stated at the second hearing:

> I remember hours of testimony regarding that [the hazards of the litigation] and it didn't impress me in the least, particularly the Government's position that — to the effect that asking Mr. Hargis and Aweco don't you think you should win? [sic].
>
> Obviously they're going to say yes, they think they should win. I am not interested in that testimony. I am interested in knowing if this is in truth and in fact a $30 million case or if it's a case in the range of five or six million. That's what I'm interested in knowing. Tr. 2/1/82, p. 10, lines 16-25, p.11 line 1.

It is evident that the judge considered facts of the case without relying totally on another's recommendation.

Seventeen specific, individual findings of fact were made by the Bankruptcy Court. In summary, the findings stated that:

> (1) Aweco executed two contracts with UAC and was being sued for breach of contract for nonperformance. Aweco's main defense was that the contracts were predicated on the finding of financing; however, no provisions in the contract were found making them contingent on the obtaining of financing.

(2) the pending litigation was complex and hotly contested for two years;

(3) Aweco incurred legal fees and expenses of approximately $720,000 and could incur additional expense of $250,000;

(4) a suit would seriously inconvenience the Debtor and its operating officers;

(5) the settlement and compromise was fair and equitable and in the best interests of the Debtor, its estate and its creditors;

(6) independent experts calculated UAC's damages at approximately $27 million (before a subsequent resale of railroad cars amounting to $9 million) with litigation liability between $10 million and $17 million if defense is not successful.

Mere reflections in the findings of fact of the standards mandated by *Anderson* do not necessarily show adequate compliance. However, in this case the findings of fact, being supported by the record, do indicate that the Bankruptcy Court considered the issues necessary for compliance with the *Anderson* guidelines in approving the compromise settlement.

Appellant's argument that the settlement was unfair to other creditors is also without merit. Aweco has assets totaling $35 million and debts in excess of $68 million (not including an additional fraudulent claim that could be alleged by UAC if litigation ensues). After the settlement is consummated, Aweco would own assets of $30 million and debts of $50 million. Any settlement by Aweco would further decrease this $50 million debt because of a decrease in the outstanding debt owed to the IRS from loss-carryback benefits of the settlement. UAC would be

receiving $5 million in exchange for a release of $18 million or more at trial. The figures that appellants have introduced to the Court to reflect the uneven fairness of the settlement in favor of Aweco do not account for the elimination of the potential liability from the Georgian suit.

Not only is the settlement not unfair to the other creditors, but these creditors would actually benefit from the settlement. Testimony was taken by the Bankruptcy Court stating that Aweco's chance at reorganization would be ruined if the suit with UAC was lost. Such a situation would diminish the return available for the creditors. With the settlement, Aweco would have a fighting chance under the reorganization plan to pay a greater percentage of its outstanding debts. The President of Aweco and the Creditors Committee recognized this in supporting the UAC settlement agreement. Therefore, the settlement should be encouraged and the Bankruptcy Court's decision affirmed.

Displacement of liens

The settlement outlined by the Bankruptcy Court necessitates displacement of federal tax liens on property to be conveyed by Aweco. A debtor is permitted to use, lease, or sell property that has liens, provided that the lienholder is provided "adequate protection" for his interest in other property. 11 U.S.C. § 363(b),(e) (1979). Appellants argue that adequate protection is not available in the remaining assets of Aweco. It appears, however, that adequate protection does exist.

Aweco's major asset is a 56⅔ percent ownership in the Lake Charles Refinery. During the December hearing, substantial testimony was received regarding the value of the refinery and the manner of its valuation. Such valuation of between $30 and $40 million was amended by the February hearing which also

disclosed a change of attitude in the desirability of continuing operations at the refinery. Testimony estabilished that despite an incompleteness in the construction of the refinery, production of certain items was possible. Suspect valuations, retainment of the facilities and investment capital needed for completion were also explored during the hearing.

The minimum value of the facility if it is immediately sold appears to be at least $22 million being evidenced by an outstanding offer from an independent source to buy the plant. After payment of the debts and encumbrances of $1.5 million, Aweco's interest of 56⅔ percent would allow allocation of over $11 million for protection of the $4 million tax lien. In addition, Aweco's interest of 56⅔ percent is only the minimum amount that can be considered. A dispute has also arisen which could place the company's ownership as high as 90 percent. This Court finds such ownership interest adequate for displacement of the federal tax liens.

Priorities of Claims

The Bankruptcy Code establishes a system of priorities in which creditors are to be paid. Appellants argue that any payment to UAC would violate the system of priorities. It appears, however, that such a payment falls within the Code's provisions.

Appellants rely on 11 U.S.C. §§ 724, 726 (1979), in establishing the priorities upon which their claims exist. Although these sections usually apply only to a Chapter 7 liquidation, these sections can apply to a Chapter 11 reorganization indirectly. Section 103(b) specifically states that subchapters I and II of Chapter 7 (in other words §§ 701, et seq. and §§ 721 et seq.) apply only in a Chapter 7 liquidation case. The case at bar is a Chapter 11 reorganization. However, in analyzing

a settlement and compromise, the Bankruptcy Court is governed by 11 U.S.C. § 1129(a)(7)(A)(ii), which states that the Court shall confirm a plan only if each class of claimants will receive or retain under the plan an interest in property of value in an amount not less than that which a holder would receive or retain if the debtor was liquidated under Chapter 7. Consequently, Chapter 7 provisions apply for analyzing the approval of the settlement.

Under a Chapter 7 liquidation, the first set of creditors to be paid in full are those with liens. 11 U.S.C. § 724 (1979). The second set of creditors to be paid are those entitled to priority under Section 507. 11 U.S.C. § 726(a)(1) (1979). Only after all secured and priority creditors are paid in full will pro rata distributions be made to general unsecured claims. 11 U.S.C. § 726(a)(2) (1979).

The IRS debt which is secured in the amount of $4 million should receive first payment. From Aweco's estate of $35 million this would decrease the available assets to $31 million and decrease the outstanding debt from $68 million to $64 million.

The next level of payment would be those priorities under Section 507. Consequently, the remaining debt to the IRS would be paid off. 11 U.S.C. § 507(6)(a) (1979). As evidenced by the claim filed with the Bankruptcy Court, this amount would be $2.5 million (however, again note that if the settlement is ultimately approved, loss-carrybacks would decrease this superior payment). Aweco's assets would now be $28.5 million with outstanding debts down to $61.5 million.

The final distribution to creditors would be made according to the third level or unsecured claims. 11 U.S.C. § 726 (1979). Under the Code and Chapter 7 this distribution would be a pro rata share of the remaining assets. Therefore, UAC's pro rata

share would be the amount of its claim divided by the total remaining debt (17/61.5ths) or almost $8 million. UAC's compromise settlement with Aweco is well under this expected share for a Chapter 7 liquidation.

The figures used in this analysis may be subject to increases or decreases occurring from further investigation (i.e. the IRS audit or UAC's fraud claim). However, these figures represent the evidence upon which the Bankruptcy Court based its ruling. Speculation as to possible changes is only one of many outside considerations observed by the Court. It is again emphasized that this Appellate Court may only overturn the Bankruptcy Court's ruling if there was an abuse of discretion. Since the settlement fits nicely within the Code's guidelines, no basis for reversal is present.

Together with the applicable sections cited above, Section 1129(b)(1) requires that a plan may be confirmed only if it does not discriminate unfairly and is fair and equitable with respect to each class of claims or interest that is impaired under, and has not accepted, the plan. 11 U.S.C. § 1129 (1979). It appears that the plan approved by the Bankruptcy Court does not violate these guidelines. The IRS and the DOE are the only two interests that have not accepted the plan. Under the above compromise settlement, each entity would receive a fair share of the assets if an immediate distribution occurred. Furthermore, as a Chapter 11 reorganization, the entity of Aweco will still be a viable organization retaining the possible ability to generate additional income to repay all remaining back-logged outstanding debts that exist under the plan. Appellants argue that the successful reorganization of Aweco is dependent upon the operation of the Lake Charles Refinery. No evidence exists on this point. Testimony was received as to the operation of the refinery. Yet such testimony also included a desire to sell the refinery because of the continual need to invest high risk capital

which is unavailable at this time. Under a Chapter 11 reorganization, an entity is allowed to sell all or any part of the property of the estate. 11 U.S.C. § 1123(a)(5)(B) (1979). Decision to sell the refinery is not equivalent to preempting the ability of Aweco to reorganize. In reaching the conclusions that Aweco could be successfully reorganized, the bankruptcy judge was not clearly erroneous.

For all the reasons set out above, judgment will be entered that Appellant's appeal be dismissed and that the Bankruptcy Court's decision and approval of the settlement and agreement is affirmed.

Signed and entered this 14th day of September, 1982.

/s/ ROBERT W. PORTER
United States District Judge

APPENDIX C

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

IN RE
AWECO, INC.
DEBTOR

Case No. BK381-00301 G
(Chapter 11)

ORDER ON DEBTOR'S NOTICE OF INTENTION TO SETTLE LITIGATION

At Dallas, Texas, in said District, this 31st day of December, 1981.

The Debtor's notice of intention to settle litigation with United American Car Company, filed herein on the 17th day of November, 1981, pertaining to that certain litigation entitled United American Car Company, Plaintiff, vs. AWECO, Inc., Defendant, presently pending in the United States District Court for the Northern District of Georgia, Rome Division, as Civil Action No. C80-26R, having duly come on for hearing, and the Court having heard and considered the objection of the United States of America Department of Energy, the United States of America Internal Revenue Service, and the objection of Sutton Investments, Inc., and it appearing that the Creditors Committee in this case announced in open Court its withdrawal of its objection to the settlement of the litigation, and the Court having heard and considered the response of the Debtor to the various objections filed herein, and having heard and considered the evidence and remarks of counsel, and having taken into consideration the probability of success in the pending litigation, with due consideration for the uncertainty in fact and law, having taken into consideration the complexity and likely duration of

the litigation, and the attendant expense, inconvenience, and delay which would result from continuance of the litigation, and the Court having considered all other factors bearing on the wisdom of the compromise and settlement, and being of the opinion that the objection of the United States of America Internal Revenue Service, the United States of America Department of Energy, and Sutton Investments, Inc., should be overruled, the Court makes the following findings of fact:

1. G. Michael Hargis, as Vice-President of AWECO, Inc., executed two contracts for the purchase of 1,000 railroad boxcars from Itel Railcar, Inc., now known as United American Car Company ("U-A").

2. AWECO, Inc. refused to perform the contracts and U-A filed suit for breach of contract.

3. The pending litigation is complex and has been hotly contested for two years.

4. AWECO, Inc. has incurred legal fees and expenses to date, in connection with the pending litigation, of approximately $720,000.00.

5. Trial of the pending litigation in Rome, Georgia, would cost the Debtor, for additional legal fees and expenses, the sum of approximately $250,000.00.

6. Trial of the pending litigation in Georgia would seriously inconvenience the Debtor and its operating officers.

7. AWECO, Inc. has defended the pending litigation primarily on the theory that the contracts were to have been subject to the obtaining of financing.

8. The Court finds no provisions in the contracts making them contingent on the obtaining of financing.

9. U-A engaged outside independent experts who calculated U-A's damage claim at approximately $27,000,000.00.

10. AWECO, Inc. has disputed the damage claim amount asserted by U-A, but it appears likely that AWECO, Inc. faces liability of between $10,000,000.00 to $17,000,000.00 if it is unsuccessful in the litigation.

11. The compromise and settlement of the pending litigation will cause the Debtor to transfer to U-A assets, including cash, of a value of approximately $5,300,000.00.

12. The compromise and settlement has the support of the Debtor, the Creditors' Committee, and the Examiner in this case.

13. The Examiner estimates that the Debtor will still have assets of approximately $30,000,000.00 after consummation of the settlement.

14. The settlement will eliminate substantial risk to the Debtor and appears to be prudent.

15. The settlement and compromise is both fair and equitable and is in the best interests of the Debtor, its estate, and its creditors.

16. The settlement will generate a net operating loss for the Debtor in the approximate amount of $5,300,000.00 and will substantially reduce the Debtor's ultimate liability for income taxes.

17. Sutton Investments, Inc. and the Internal Revenue Service, with respect to the displacement of their lien claims as a result of the settlement, will be adequately protected by the transfer of their lien rights to other assets of the Debtor as to which their existing lien rights do not presently apply.

IT IS THEREFORE ORDERED that the Debtor be and it hereby is authorized to consummate settlement of the litigation with United American Car Company pursuant to the terms of the settlement agreement filed with the Court on November 17, 1981, as an attachment to the Debtor's notice of intention to settle litigation, as such settlement agreement was orally modified at the time of hearing by extending the December 23, 1981 date for approval in Paragraph 16 to December 31, 1981, and by extending the deadline for full consummation of closing to February 1, 1982, such settlement agreement being effective this date; and

IT IS FURTHER ORDERED that the judgment lien of Sutton Investments, Inc., on the Brookwood Apartments in Collin County, Texas, be and it hereby is ordered displaced and held for naught as to the Brookwood Apartments in Collin County, Texas, and to the proceeds of sale thereof; and

IT IS FURTHER ORDERED that the liens of Sutton Investments, Inc., and the United States of America Internal Revenue Service, if any, on the Debtor's property situated in California, and referred to as the Vacaville property in the settlement agreement, be and they hereby are displaced and held for naught, both as to the property and the proceeds of sale thereof, if any; and

IT IS FURTHER ORDERED that the judgment lien of Sutton Investments, Inc., and the income tax lien in favor of the Internal Revenue Service, insofar as they validly attached to the

property described in the settlement agreement as the Jupiter Road property, be and they hereby are displaced and held for naught, both as to the property and the proceeds of sale.

IT IS FURTHER ORDERED that the liens of Sutton Investments, Inc., and Internal Revenue Service with respect to the Vacaville property, the Jupiter Road property, and the Brookwood Apartments, to the extent such liens are valid liens which are hereby displaced as to said properties, shall attach to the properties of the Debtor not required for and remaining after consummation of the settlement, including, without limitation, real estate, personal property, contract rights, notes and accounts receivable, interest in subsidiaries and joint ventures, and any other assets as to which said lien claimants previously had no lien claim.

IT IS FURTHER ORDERED that the initial payment to United American Car Company pursuant to the settlement agreement shall be the amount of $1,000,000.00 cash, to be paid to United American Car on the first business day after the expiration of ten days from the date of this order; and

IT IS FURTHER ORDERED that, unless the parties further extend the date for final consummation of the compromise and settlement agreement, the same shall be consummated on or before February 1, 1982; and

IT IS FURTHER ORDERED that no payments or other transfers of property pursuant to the settlement agreement shall be made until the expiration of ten days from the date of this order.

/s/ DEAN M. GANDY

Bankruptcy Judge

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 82-1621

D. C. Docket No. CA3-82-0474-F

In the Matter of: AWECO, INC.,

Debtor.

UNITED STATES OF AMERICA,
(Internal Revenue Service and
Department of Energy),

Plaintiffs-Appellants,

versus

AWECO, INC.,

Debtor-Appellee,

and

UNITED AMERICAN CAR COMPANY,

Appellee.

Appeal from the United States District Court for the
Northern District of Texas

Before GOLDBERG, GEE and TATE, Circuit Judges.

JUDGMENT

This cause came on to be heard on the record on appeal and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the order of the District Court appealed from in this cause be, and the same is hereby, vacated and that this cause be, and the same is hereby remanded to said District Court with instructions in accordance with the opinion of this Court;

IT IS FURTHER ORDERED that appellees pay to appellants the costs on appeal, to be taxed by the Clerk of this Court.

FEBRUARY 21, 1984

ISSUED AS MANDATE:

APPENDIX E

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 82-1621

In the Matter of AWECO, INC., *Debtor.*

UNITED STATES OF AMERICA,
(Internal Revenue Service and Department of Energy),
Plaintiffs-Appellants,

v.

AWECO, INC., *Debtor-Appellee.*

and

UNITED AMERICAN CAR COMPANY,
Appellee.

Appeal from the United States District Court for the
Northern District of Texas

ON PETITIONS FOR REHEARING AND SUGGESTIONS FOR REHEARING EN BANC

(Opinion February 21, 1984, 5 Cir., 198.. , ... F. 2d .....)
(April 23, 1984)

Before GOLDBERG, GEE and TATE, Circuit Judges.

PER CURIAM:

(X) The Petitions for Rehearing are DENIED and no member of this panel nor Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc, (Federal Rules of Appellate Procedure and Local Rule 35) the Suggestions for Rehearing En Banc are DENIED.

ENTERED FOR THE COURT:

/s/ THOMAS GIBBS GEE
United States Circuit Judge

APPENDIX F

APPENDIX F

Bankruptcy Act of 1898

Bankruptcy Act § 221 (11 U.S.C. § 621 (1976))

§ 621. Confirmation by court

The judge shall confirm a plan if satisfied that —

(1) the provisions of subchapters VII and X of this chapter and Section 599 of this title have been complied with;

(2) the plan is fair and equitable, and feasible;

(3) the proposal of the plan and its acceptance are in good faith and have not been made or procured by means or promises forbidden by this title;

(4) all payments made or promised by the debtor or by a corporation issuing securities or acquiring property under the plan or by any other person, for services and for costs and expenses in, or in connection with, the proceeding or in connection with the plan and incident to the reorganization, have been fully disclosed to the judge and are reasonable or, if to be fixed after confirmation of the plan, will be subject to the approval of the judge; and

(5) the identity, qualifications, and affiliations of the persons who are to be directors or officers, or voting trustees, if any, upon the consummation of the plan, have been fully disclosed, and that the appointment of such persons to such offices, or their continuance therein, is equitable, compatible with the interests of the creditors and stockholders and consistent with public policy.

Bankruptcy Act § 27 (11 U.S.C. § 50 (1976))

§ 50. Compromises

The receiver or trustee may, with the approval of the court, compromise any controversy arising in the administration of the estate upon such terms as he may deem for the best interest of the estate.

Bankruptcy Code

Bankruptcy Code § 1125 (11 U.S.C. § 1125 (1982))

§ 1125. Postpetition disclosure and solicitation

(a) In this section —

(1) "adequate information" means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan; and

(2) "investor typical of holders of claims or interests of the relevant class" means investor having —

(A) a claim or interest of the relevant class;

(B) such a relationship with debtor as the holders of other claims or interests of such class generally have; and

(C) such ability to obtain such information from sources other than the disclosure required by this section as holders [of] claims or interests in such class generally have.

(b) An acceptance or rejection of a plan may not be solicited after the commencement of the case under this title from a holder of a claim or interest with respect to such claim or interest, unless, at the time of or before such solicitation, there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information. The court may approve a disclosure statement without a valuation of the debtor or an appraisal of the debtor's assets.

(c) The same disclosure statement shall be transmitted to each holder of a claim or interest of a particular class, but there may be transmitted different disclosure statements, differing in amount, detail, or kind of information, as between classes.

(d) Whether a disclosure statement contains adequate information is not governed by any otherwise applicable non-bankruptcy law, rule, or regulation, but an agency or official whose duty is to administer or enforce such a law, rule, or regulation may be heard on the issue of whether a disclosure statement contains adequate information. Such an agency or official may not appeal from an order approving a disclosure statement.

(e) A person that solicits, in good faith and in compliance with the applicable provisions of this title, or that participates, in good faith and in compliance with the applicable provisions of this title, in the offer, issuance, sale, or purchase of a security, offered or sold under the plan, of the debtor, of an affiliate participating in a joint plan with the debtor, or of a newly organized successor to the debtor under the plan, is not liable, on account of such solicitation or participation, for violation of any applicable law, rule, or regulation governing the offer, issuance, sale, or purchase of securities.

Bankruptcy Code § 1129 (11 U.S.C. § 1129 (1982))

§ 1129. Confirmation of plan

(a) The court shall confirm a plan only if all of the following requirements are met:

(1) The plan complies with the applicable provisions of this chapter.

(2) The proponent of the plan complies with the applicable provisions of this chapter.

(3) The plan has been proposed in good faith and not by any means forbidden by law.

(4)(A) Any payment made or promised by the proponent, by the debtor, or by a person issuing securities or acquiring property under the plan, for services or for costs and expenses in, or in connection with, the case, or in connection with the plan and incident to the case, has been disclosed to the court; and

(B)(i) any such payment made before confirmation of the plan is reasonable; or

(ii) if such payment is to be fixed after confirmation of the plan, such payment is subject to the approval of the court as reasonable.

5(A)(i) The proponent of the plan has disclosed the identity and affiliations of any individual proposed to serve, after confirmation of the plan, as a director, officer, or voting trustee of the debtor, an affiliate of the debtor participating in a joint plan with the debtor, or a successor to the debtor under the plan; and

(ii) the appointment to, or continuance in, such office of such individual, is consistent with the interests of creditors and equity security holders and with public policy;

(B) The proponent of the plan has disclosed the identity of any insider that will be employed or retained by the reorganized debtor, and the nature of any compensation for such insider.

(6) Any regulatory commission with jurisdiction, after confirmation of the plan, over the rates of the debtor has approved any rate change provided for in the plan, or such rate change is expressly conditioned on such approval.

(7) With respect to each class —

(A) each holder of a claim or interest of such class —

(i) has accepted the plan; or

(ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date; or

(B) if section 1111(b)(2) of this title applies to the claims of such class, each holder of a claim of such class will receive or retain under the plan on account of such claim property of a value, as of the effective date of the plan, that is not less than the value of such creditor's interest in the estate's interest in the property that secures such claims.

(8) With respect to each class —

(A) such class has accepted the plan; or

(B) such class is not impaired under the plan.

(9) Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that —

(A) with respect to a claim of a kind specified in section 507(a)(1) or 507(a)(2) of this title, on the effective date of the plan, the holder of such claim will receive on account of such claim cash equal to the allowed amount of such claim;

(B) with respect to a class of claims of a kind specified in section 507(a)(3), 507(a)(4), or 507(a)(5) of this title, each holder of a claim of such class will receive —

(i) if such class has accepted the plan, deferred cash payments of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) if such class has not accepted the plan, cash on the effective date of the plan equal to the allowed amount of such claim; and

(C) with respect to a claim of a kind specified in section 507(a)(6) of this title, the holder of such claim will receive on account of such claim deferred cash payments, over a period not exceeding six years after the date of assessment of such claim, of a value, as of the effective date of the plan, equal to the allowed amount of such claim.

(10) At least one class of claims has accepted the plan, determined without including any acceptance of the plan by any insider holding a claim of such class.

(11) Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.

(b)(1) Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A) With respect to a class of secured claims, the plan provides —

(i)(I) that the holders of such claims retain the lien securing such claims, whether the property subject to such lien is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the lien securing such claims, free and clear of such lien, with such lien to attach to the proceeds of such sale, and the treatment of such lien on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.

(B) With respect to a class of unsecured claims —

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain on account of such junior claim or interest any property.

(C) With respect to a class of interests —

(i) the plan provides that each holder of an interest of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which such holder is entitled, and the value of such interest; or

(ii) the holder of any interest that is junior to the interests of such class will not receive or retain under the plan on account of such junior interest any property.

(c) Notwithstanding subsections (a) and (b) of this section and except as provided in section 1127(b) of this title, the court may confirm only one plan, unless the order of confirmation in the case has been revoked under section 1144 of this title. If the requirements of subsections (a) and (b) of this section are met with respect to more than one plan, the court shall consider the preferences of creditors and equity security holders in determining which plan to confirm.

(d) Notwithstanding any other provision of this section, on request of a party in interest that is a governmental unit, the court may not confirm a plan if the principal purpose of the plan is the avoidance of taxes or the avoidance of section 5 of the Securities Act of 1933 (15 U.S.C. 77e).

Rules of Bankruptcy Procedure

Former Rule 919 (11 U.S.C. Rule 919 (1976))

Rule 919. Compromise and arbitration

(a) Compromise. On application by the trustee or receiver and after hearing on notice to the creditors as provided in Rule 203(a) and to such other persons as the court may designate, the court may approve a compromise or settlement.

(b) Arbitration. On stipulation of the parties to any controversy affecting the estate the court may authorize the matter to be submitted to final and binding arbitration.

Bankruptcy Rules

Current Rule 9019 (11 U.S.C.A. Rule 9019 (West 1984))

Rule 9019. Compromise and Arbitration

(a) Compromise

On motion by the trustee and after a hearing on notice to creditors, the debtor and indenture trustees as provided in Rule 2002(a) and to such other persons as the court may designate, the court may approve a compromise or settlement.

(b) Authority to compromise or settle controversies within classes

After a hearing on such notice as the court may direct, the court may fix a class or classes of controversies and authorize the trustee to compromise or settle controversies within such class or classes without further hearing or notice.

(c) Arbitration

On stipulation of the parties to any controversy affecting the estate the court may authorize the matter to be submitted to final and binding arbitration.

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No. 83-2000

In the Supreme Court of the United States

OCTOBER TERM, 1984

AWECO, INC., AND UNITED-AMERICAN CAR CO.,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

REX E. LEE
Solicitor General
GLENN L. ARCHER, JR.
Assistant Attorney General
WYNETTE J. HEWETT
ELAINE F. FERRIS
Attorneys
Department of Justice
Washington, D.C. 20530
(202) 633-2217

BEST AVAILABLE COPY

QUESTION PRESENTED

Whether the court of appeals in this bankruptcy case erred in remanding for further factual findings to determine whether a proposed distribution of assets in settlement of a general unsecured creditor's claim was "fair and equitable" to senior creditors.

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BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A12) is reported at 725 F.2d 293. The opinions of the district court (Pet. App. B1-B10) and of the bankruptcy court (Pet. App. C1-C5) are not officially reported.

JURISDICTION

The judgment of the court of appeals (Pet. App. D1) was entered on February 21, 1984. A petition for rehearing was denied on April 23, 1984 (Pet. App. E1). The petition for a writ of certiorari was

filed on June 7, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

This is a reorganization proceeding under Chapter 11 of the Bankruptcy Code (11 U.S.C.). Petitioner Aweco, Inc., is the debtor-in-possession. Petitioner United-American Car Co. (United) held an unsecured, unliquidated claim against Aweco for breach of contract (Pet. App. A2-A3). In 1981, Aweco, without having formulated a plan of reorganization for submission to its creditors, negotiated a settlement with United, agreeing to make an immediate payment of $5.3 million in satisfaction of the latter's unsecured claim (*ibid.*). Four parties, including the Internal Revenue Service, filed with the bankruptcy court objections to the proposed settlement.[1]

At the hearing, Aweco contended that approval of the settlement would enhance its prospects for successful rehabilitation. Its president testified that the key to the debtor's successful reorganization was the

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[1] The IRS held secured and priority tax claims against Aweco totalling approximately $6.1 million (Pet. App. A2). In addition, the IRS has recently completed an audit of Aweco and has filed an amended proof of claim asserting total tax liabilities exceeding $28 million. Other parties objecting to the proposed settlement were the Department of Energy, which holds an unsecured claim in the amount of $45 million based on a determination that Aweco overcharged its customers for oil; Sutton Investments, which holds a secured claim in the amount of approximately $7.6 million; and the Creditors' Committee. The Creditors' Committee withdrew its objection at the outset of the bankruptcy court hearing. Sutton withdrew its objection when the bankruptcy court subsequently granted it a lien on certain of Aweco's assets (Pet. App. A3-A4 n.5).

profitable operation of its chief asset, an oil refinery with a history of operating losses and in a currently deteriorating state (Pet. App. A4-A5). A court-appointed examiner estimated that Aweco would still have assets worth $30 million after the $5.3 million was distributed to United (*id.* at A5). His testimony, however, listed properties (including the refinery) totalling only $17.5 million in value (*ibid.*) The examiner did not know whether the refinery was encumbered by prior liens (*id.* at A10). The bankruptcy court approved the settlement at the close of this hearing, concluding in a brief opinion that the settlement was "fair and equitable" and was in the best interests of Aweco's creditors (*id.* at C3).

Upon the IRS' motion for reconsideration, the bankruptcy court held a second hearing, announcing at the outset that it had doubts about the value of the refinery (Pet. App. A5). Aweco changed its position at this hearing, indicating that it planned to sell the refinery rather than operate it (*id.* at A5-A6). The IRS' motion for a continuance to develop evidence about the refinery's value was denied (*id.* at A6), and the bankruptcy court again approved the settlement, this time without an opinion.

The district court affirmed (Pet. App. B1-B10). It reasoned that the proposed settlement would reduce Aweco's liabilities, that it would improve the likelihood of Aweco's rehabilitation under its plan of reorganization,[2] that the IRS' secured claim was adequately protected, and that the government would receive a fair share of Aweco's assets (*id.* at B5-B10).

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[2] The district court apparently was under the mistaken impression (see Pet. App. B9) that the bankruptcy court had approved a plan of reorganization in this case.

The Fifth Circuit vacated the district court's order and remanded the case to the bankruptcy court (Pet. App. A1-A12). The court of appeals held that the bankruptcy judge had abused his discretion in approving Aweco's settlement with a junior creditor absent reasonable assurance that the settlement accorded with the "fair and equitable" standard, *i.e.*, that priority of payment would be respected as to senior creditors who objected thereto (*id.* at A9). The court further held that the record did not present a sufficient factual foundation to permit a conclusion as to whether the "fair and equitable" standard had been met (*id.* at A10-A12).

ARGUMENT

Petitioners seek review of an interlocutory decision that does not preclude the possibility that they may prevail on remand. There is no need for this Court's intervention at the present stage of the case. In any event, the decision below is correct, there is no conflict among the circuits on the question presented, and there is no other basis for further review.

1. Petitioners' chief contention (Pet. 6-11) is that the court of appeals erred in applying the "fair and equitable standard" in the circumstances of this case. They concede (Pet. 9), as they must, that application of that standard would be proper if Aweco's settlement of United's claim were incorporated in a proposed plan of reorganization. The new Bankruptcy Code explicitly provides that a bankruptcy court may confirm a plan of reorganization over creditors' objections only "if the plan does not discriminate unfairly, *and is fair and equitable*, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan" (11 U.S.C. 1129(b)(1) (emphasis added)). The legisla-

tive history, moreover, makes clear that the term "fair and equitable" as used in Section 1129(b)(1) "codifies the absolute priority rule"—the bankruptcy rule of long standing that senior creditors have priority of payment over junior ones—"from the dissenting class on down." H.R. Rep. 95-595, 95th Cong., 1st Sess. 413 (1977). And this Court has held that bankruptcy courts have "the duty * * * to determine that a proposed compromise forming part of a reorganization plan is fair and equitable." *Protective Committee* v. *Anderson*, 390 U.S. 414, 424 (1968). See 6A *Collier on Bankruptcy* ¶ 11.06, at 222-223 n.55 (14th ed. 1977). Thus, if Aweco's proposed compromise of United's claim had been presented as part of a plan of reorganization, and if the IRS (as a senior creditor) had objected to the settlement in that context, the bankruptcy court plainly could have approved the settlement only by finding that the "fair and equitable" standard had been met.

Petitioners note, however, that Aweco proffered its settlement of United's claim *before* proposing a plan of reorganization, and contend that the court of appeals "erroneously graft[ed] the fair and equitable standard * * * onto pre-plan-of-reorganization compromises" (Pet. 10). This contention is wrong, as a matter both of precedent and of common sense. In *Protective Committee* v. *Anderson*, *supra*, this Court emphasized that "[c]ompromises are 'a normal part of the process of reorganization,'" that "[i]n administering reorganization proceedings in an economical and practical manner it will often be wise to arrange the settlement of claims as to which there are substantial and reasonable doubts," and that the requirement "that plans of reorganization

be both 'fair and equitable,' appl[ies] to compromises just as to other aspects of reorganizations" (390 U.S. at 424 (citing cases)). Although the compromise at issue there happened to be incorporated in one of many plans of reorganization proposed by the debtor, there is nothing in the Court's reasoning to suggest that the protection offered to senior creditors by the "fair and equitable" standard should hinge solely on the timing and context chosen by the debtor for submission of the compromise.[3]

Petitioners' argument is likewise at odds with common sense. As noted above, Congress plainly intended the "fair and equitable" standard to be applied, at the behest of objecting senior creditors, to settlements that are part of a reorganization plan. The content of a reorganization plan, however, as well as the timing of its submission, are largely in the debtor's control. On petitioners' theory, therefore, a debtor could deliberately postpone formulation of a plan, submit settlements of selected junior claims for approval,[4] and exhaust the estate's assets by distributions to those junior creditors before a plan of reorganization was even proposed. That result, obviously, would make the protection Congress intended to guarantee senior creditors by the "fair and equi-

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[3] There is thus no merit to petitioners' contention (Pet. 18-20) that the decision below conflicts with *Protective Committee* v. *Anderson, supra,* in applying the "fair and equitable" standard to settlements of the sort involved here.

[4] On petitioners' theory (Pet. 18-19), the bankruptcy court would be required to approve such pre-plan settlements provided only that they were fair as between the debtor and the settling party, regardless of the effect on other creditors of the resulting distribution of assets.

table" standard a hollow protection indeed.[5] The court of appeals thus correctly concluded that the "underlying policies" of the Bankruptcy Code mandate "a limited extension of the fair and equitable standard [such that] a bankruptcy court abuses its discretion in approving a settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors" (Pet. App. A9).[6]

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[5] Petitioners suggest (Pet. 16-18) that there are other remedies to protect senior creditors, such as seeking dismissal of the reorganization proceedings or seeking to convert the case to a liquidating bankruptcy. See 11 U.S.C. 1112(b). Those remedies may well be appropriate where a debtor is systematically distributing its assets pursuant to piecemeal settlements of junior claims. But the existence of those remedies furnishes no basis for denying relief in the circumstances involved here, where a senior creditor would be injured by the distribution of a substantial portion of the debtor's assets to a single junior creditor.

[6] Petitioners correctly note (Pet. 8-9 & n.11) that Congress, in enacting the new Bankruptcy Code, intended to eliminate much of the inflexibility that had characterized proceedings under the Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (previously codified in various sections of 11 U.S.C. (1976 ed.)). The flexibility Congress envisioned, however, did not include permitting debtors to eviscerate, in the manner petitioners propose, the protection afforded senior creditors by the "fair and equitable" standard. Congress did modify that standard in some respects, providing that it would apply only if senior creditors objected to the terms of the debtor's proposed reorganization, whereas under the 1898 Act the standard's application was mandatory even in the absence of senior creditors' objections. See H.R. Rep. 95-595, *supra*, at 222, 224. Congress likewise made clear that the "fair and equitable" standard did not apply to arrangements, which did not affect secured claims, for the obvious reason that senior creditors in such cases did not need the protection the standard affords. *Id.* at 222, 225,

2. Assuming that the "fair and equitable" standard applies to the settlement at issue, petitioners contend (Pet. 11-13) that the court of appeals erred in considering the liquidation value, as opposed to the going-concern value, of Aweco's assets in determining whether the standard was met, that is, in determining whether the proposed distribution to United would leave the estate with sufficient assets to satisfy senior claims. This contention is meritless. To begin with, the court of appeals, as petitioners recognize (Pet. 11), only "suggest[ed]" that liquidation value was the relevant figure. The court *held* that the record was inadequate to permit an informed decision about the settlement's "fairness" and "equity" (Pet. App. A12), without specifying what criterion the bankruptcy court should use to make that determination on remand.[7]

In any event, the court of appeals' suggestion was clearly reasonable on the facts presented. Congress intended to permit flexibility regarding the type of valuation to be used in reorganization proceedings,

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242, 250-251. See also H.R. Rep. 2320, 82d Cong., 2d Sess. 21 (1952); *SEC* v. *United States Realty & Improvement Co.*, 310 U.S. 434 (1940); 9 *Collier on Bankruptcy* ¶ 9.18[2.1] (14th ed. 1978). Since both of these modifications of the "fair and equitable" standard were consistent with continuing protection for senior creditors' rights, neither furnishes any support for petitioners' contention (Pet. 8-11) that the standard's application would be at odds with congressional intent here.

[7] At one point, petitioners appear to contend (Pet. 12) that Congress intended to dispense altogether with asset valuations in reorganization proceedings. But Congress fully appreciated that application of the fair and equitable standard "requires a full valuation of the debtor as the absolute priority rule [did] under [prior] law" (H.R. Rep. 95-595, *supra*, at 224).

adopting neither liquidation value nor going-concern value as an absolute test. H.R. Rep. 95-595, *supra*, at 224. In this case, Aweco proposed no plan to rehabilitate its operations, and its president testified (Pet. App. A6) that Aweco intended to sell rather than to operate the refinery that constituted its principal asset. Under these circumstances, the refinery's going-concern value is of no practical significance to its senior creditors, for it is the amount realized upon liquidation of the refinery that will affect the amount available for distribution to them in satisfaction of their claims. Thus, to the extent the opinion below can be read to support the use of liquidation value on remand, the opinion is correct.

3. Petitioners suggest (Pet. 4) that failure to uphold the instant settlement will hinder Aweco's successful rehabilitation. That argument assumes that Aweco would be required to pay United's claim in full unless the settlement were approved. Under the Bankruptcy Code's "cram-down" provisions, however, a plan of reorganization could be confirmed under which United (a junior unsecured creditor) would receive *nothing* for its claim, if Aweco's assets were inadequate to satisfy claims senior to United's. See 11 U.S.C. 1129(b); H.R. Rep. 95-595, *supra*, at 224.

Petitioners similarly contend (Pet. 13-15) that the decision below will hinder successful reorganizations by enabling a single senior creditor to block settlement of junior claims. But the "fair and equitable" standard that Congress adopted gives a single senior creditor precisely that power in the case of compromises incorporated in a reorganization plan. No policy of bankruptcy law supports a different result merely because the compromise is proffered (say) a few months before a plan is proposed. Congress did

not intend to promote the piecemeal distribution of a debtor's assets as a means of preferring junior creditors. Congress intended, rather, to foster the development of feasible plans of reorganization that respect creditors' relative rights.

4. Finally, there is no merit to petitioners' assertion (Pet. 18-21) that the decision below conflicts with the Eighth Circuit's decision in *In re Flight Transportation Corp. Securities Litigation*, 730 F.2d 1128 (1984). That case involved the settlement of a dispute as to whether an escrow account belonged to the debtor in a Chapter 11 proceeding. Certain parties, who claimed to have been defrauded, contended that the escrow account belonged to them and hence was not properly an asset of the debtor's estate (730 F.2d at 1134). In partially affirming the settlement, the Eighth Circuit emphasized that the settlement did not determine the distribution of the debtor's assets to its creditors (*id.* at 1134-1135, 1139), and the court was thus not required to consider whether distributions from a bankruptcy estate pursuant to a settlement must meet the "fair and equitable" standard.[8] In this case, by contrast, Aweco proposed to distribute a substantial portion of its assets to a general unsecured creditor, without showing that the assets retained in the bankruptcy estate were sufficient to satisfy senior claims. The Fifth Circuit correctly applied the "fair and equitable" standard in these circumstances, and nothing in the Eighth Circuit's decision is to the contrary.

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[8] The Eighth Circuit did inquire whether the settlement was "fair, adequate and reasonable" in resolving the dispute concerning ownership of the escrow fund (730 F.2d at 1136-1138, 1139).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

REX E. LEE
Solicitor General

GLENN L. ARCHER, JR.
Assistant Attorney General

WYNETTE J. HEWETT
ELAINE F. FERRIS
Attorneys

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UNITED STATES OF AMERICA,
Respondent.

REPLY BRIEF IN SUPPORT OF PETITION FOR CERTIORARI

FRANK C. JONES
Counsel of Record

WALTER W. DRIVER, JR.
JAMES A. PARDO, JR.

KING & SPALDING
2500 Trust Company Tower
Atlanta, Georgia 30303
(404) 572-4600

Attorneys for Petitioner United-American Car Co.

D. M. LYNN
Counsel of Record

STUART M. REYNOLDS, JR.

MOORE & PETERSON
A Professional Corporation
2800 First City Center
Dallas, Texas 75201-4621
(214) 754-4800

MAHON & WINSTON
2430 One Main Place
Dallas, Texas 75250

Attorneys for Petitioner AWECO, Inc.

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Respondent.

REPLY BRIEF IN SUPPORT OF PETITION FOR CERTIORARI

Petitioners, AWECO, Inc. ("Aweco") and United-American Car Co. ("United") hereby file this reply brief in support of their petition for writ of certiorari.

ARGUMENT

I.

THE LEGAL ISSUE PRESENTED BY THIS CASE IS RIPE FOR DETERMINATION

The United States in its brief in opposition suggests that this Court ought not grant a writ of certiorari because the decision of the court of appeals is "interlocutory" and "does not preclude the possibility that [Aweco and United] may prevail on remand." Brief for

Respondent at 4.[1] Such a suggestion is without merit as it ignores the direct conflict between the holding of the Fifth Circuit in this case and the Eighth Circuit in *In re Flight Transportation Corp. Securities Litigation*, 730 F.2d 1128 (8th Cir. 1984); the mandate of *Protective Committee v. Anderson*, 390 U.S. 414 (1968); and Congress' manifest intent in the Bankruptcy Reform Act of 1978 (the "Bankruptcy Code").[2]

At issue in this case is the application of the absolute priority rule developed under Chapter X of the repealed Bankruptcy Act of 1898 (the "Bankruptcy Act")[3] to a preconfirmation compromise and settlement of a claim made in a bankruptcy case arising under Chapter 11 of the Bankruptcy Code. Aweco, as debtor, and United, as creditor, urge in their petition for writ of certiorari that the court of appeals erred in its "extension" of the absolute priority rule to such a compromise and settlement in the face of Congressional policy set forth in the new Bankruptcy Code. This Court should grant a writ of certiorari and reverse the judgment of the court of appeals to prevent any continuing precedential effect of the lower court's opinion. Until modified by this Court, the opinion of the Fifth Circuit will erroneously bind other panels of that court and the district and bankruptcy courts in that circuit, *cf. Hutto v. Davis*, 454 U.S. 370, 375 (1982) (precedent of higher federal court "must be fol-

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[1] The United States does not dispute that United and Aweco properly have invoked the jurisdiction of this Court under 28 U.S.C. § 1254(1) (1982).

[2] Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101-15326 (1982), *amended by* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984).

[3] Bankruptcy Act of 1898, as amended, 11 U.S.C. §§ 1-1103 (1976) (repealed effective Oct. 1, 1979).

lowed by the lower federal courts no matter how misguided the judges of those courts may think it to be"), when all trial courts are entitled to have the proper legal standard enunciated. *See also Washington v. Watkins*, 655 F.2d 1346, 1354 n.10 (5th Cir. 1981), *cert. denied*, 456 U.S. 949 (1982). Moreover, even outside of the Fifth Circuit great deference can be expected to be shown to the opinion of the court of appeals notwithstanding this Court's prior holding in *Protective Committee v. Anderson*, 390 U.S. 414 (1968), and the opinion of the Eighth Circuit in *In re Flight Transportation Corp. Securities Litigation*, 730 F.2d 1128 (8th Cir. 1984).

Accordingly, this Court should recognize the legal issue presented in this case to be ripe for determination and should grant the writ of certiorari to establish as a matter of law the correct standard for approval of compromises and settlements under the Bankruptcy Code, the application of *Protective Committee* under that statute, and to avoid the manifest injustice of remand of this case with instructions to reconsider the compromise based upon the Fifth Circuit's improper standard.

II.

CONGRESS DID NOT INTEND THAT THE ABSOLUTE PRIORITY RULE APPLY TO PRECONFIRMATION COMPROMISES IN CASES UNDER CHAPTER 11

The United States argues that the court of appeals properly applied the absolute priority rule to the preconfirmation compromise and settlement in this case to permit the United States "to block [the] settlement of junior claims." Brief for Respondent at 4-7, 9-

10. That argument is without support under applicable law[4] and is contrary to Congress' intent that the fair and equitable standard and the absolute priority rule that is its corollary have only a limited application in reorganization cases brought under the Bankruptcy Code.

One of the principal purposes of Congress in enacting Chapter 11 of the Bankruptcy Code was to limit severely application of the absolute priority rule and the difficulties and abuses it had generated under repealed Chapter X of the Bankruptcy Act. *See, e.g.*, H.R. Rep. No. 595, 95th Cong., 1st Sess. at 221-24 (1977), *reprinted in*, 1978 U.S. Code Cong. & Ad. News 5963. Thus, under the new Bankruptcy Code the fair and equitable standard, including the absolute priority rule, applies only to confirmations of plans of reorganization under section 1129(b).[5] The "limited extension" of the absolute priority rule by the Fifth Circuit defeats the intent of Congress.

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[4] The court of appeals in its opinion and the United States in its brief *cite no case* in which the fair and equitable standard and the absolute priority rule have been applied to compromise and settlement agreements outside of a plan of reorganization. *See* Petition for Certiorari at 19 n.28. *See also infra* at 8.

[5] The fair and equitable standard and the absolute priority rule do not apply to the confirmation of all plans of reorganization in cases under Chapter 11. *See* 11 U.S.C. § 1129(a) (1982) (permitting confirmation of plans of reorganization without regard to the absolute priority rule). Similarly, neither former Bankruptcy Rule 919 nor current Bankruptcy Rule 9019, which deal with preconfirmation compromises and settlements, contain any reference to the fair and equitable standard or the absolute priority rule. *Compare* Bankr. R. 919 (superseded) *and* Bankr. R. 9019 *with* 11 U.S.C. § 1129(b)(1) (1982).

Section 1129(b) of the Bankruptcy Code, 11 U.S.C. § 1129(b) (1982), is a device that may be used *solely* by a plan proponent[6] to achieve confirmation of a plan of reorganization. That section, and the fair and equitable standard and absolute priority rule contained therein, apply only in the event that the proponent of a plan of reorganization seeks confirmation of that plan when one or more classes of creditors fails to accept the plan of reorganization. *The fair and equitable standard and the absolute priority rule have no other application in cases under Chapter 11 and, in particular, do not apply to preconfirmation compromise and settlement agreements approved under Rule 9019.*

The United States contends that Aweco's and United's position on the limited application of the absolute priority rule is "at odds with common sense," claiming that under petitioners' interpretation of the Bankruptcy Code "a debtor could deliberately postpone formulation of a plan, submit settlements of selected junior claims for approval, and exhaust the estate's assets by distributions to those junior creditors before a plan of reorganization was even proposed." Brief for Respondent at 6. That contention is wholly without merit as it fails to consider the specific protections afforded to senior creditors under the Bank-

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[6] There is no merit to the United States' argument that Congress intended that the fair and equitable standard be applied at the behest of objecting senior creditors. Brief for Respondent at 6. Rather, the legislative history makes clear that section 1129(b) was intended by Congress to be an "alternative confirmation standard, . . . called into play *only on the request of the proponent of the plan.*" 124 Cong. Rec. H 11,104 (daily ed. Sept. 28, 1978) (emphasis supplied); 124 Cong. Rec. S 17,420 (daily ed. Oct. 6, 1978) (emphasis supplied).

ruptcy Code other than application of the absolute priority rule.

All creditors have substantial protection against capricious actions by a debtor.[7] As in the instant case, notice will be given and hearing had concerning settlement of a dispute in a Chapter 11 case. *See* Bankr. R. 9019. An objecting creditor has a host of remedies to protect its position. For example, if it is a secured creditor as the Respondent here asserts, it may seek "adequate protection" of its interest. 11 U.S.C. §§ 361-64 (1982). Until a plan of reorganization is filed and reaches a hearing on confirmation, however, there is no provision in the Bankruptcy Code suggesting that the reference to the fair and equitable standard under the limited circumstances in section 1129(b) may be expanded to hinder a debtor in the administration of the case and the conduct of its business or that such standard must be applied by the bankruptcy court to any matter coming before it.

This Court should, therefore, grant the writ of certiorari and reverse the judgment of the court of appeals to prevent the frustration of Congress' intent.

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[7] Elsewhere in its brief the United States expressly acknowledges that "remedies may well be appropriate where a debtor is systematically distributing its assets pursuant to piecemeal settlements of junior claims. Brief for Respondent at 7 n.5. Notwithstanding the adequacy of those statutory remedies, the United States contends that no basis exists to deny additional protection to senior creditors through application of the absolute priority rule. With due respect, *the basis from which to deny application of the absolute priority rule in this case is Congress' intent that the rule be applied only to confirmations of plans of reorganization under section 1129(b).*

III.

THE DECISION OF THE FIFTH CIRCUIT CONFLICTS WITH APPLICABLE DECISIONS OF THIS COURT AND OF THE EIGHTH CIRCUIT

In the petition for certiorari Aweco and United contend that the decision of the court of appeals conflicts with the decision of this Court in *Protective Committee v. Anderson*, 390 U.S. 414 (1968) and with the recent decision of the Eighth Circuit in *In re Flight Transportation Corp. Securities Litigation*, 730 F.2d 1128 (8th Cir. 1984). The United States in its brief attempts unsuccessfully to dismiss out of hand the obvious conflict with *Protective Committee* and to distinguish *Flight Transportation*. Brief for Respondent at 6 n.3, 10. Those unsuccessful attempts are without merit.

In *Protective Committee* this Court stated that no determination could be made as to whether to approve a compromise and settlement agreement until

> the bankruptcy judge has apprised himself of all facts necessary for an intelligent and objective opinion of the probabilities of ultimate success should the claim be litigated. Further, the judge should form an educated estimate of the complexity, expense, and likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise.

390 U.S. at 424. This standard is essentially the standard set out in *Drexel v. Loomis*, 35 F.2d 800, 806 (8th

Cir. 1929) and applied by other courts in cases under Chapter 11. *See, e.g., In re Salem Mortgage Co.*, 34 Bankr. 902, 909 (Bankr. E.D. Mich. 1983); *In re Sherman Homes, Inc.*, 28 Bankr. 176, 177 (Bankr. D. Me. 1983); *In re Oceanside Properties, Inc.*, 14 Bankr. 95, 99 (Bankr. D. Hawaii 1981). The orders of the bankruptcy court and the district court in this case explicitly and faithfully conform to that standard which was not given deference by the Fifth Circuit.

The United States totally ignores the pronouncement of that standard in *Protective Committee* and transplants the absolute priority rule applied to the plan of reorganization in *Protective Committee* to the preconfirmation compromise and settlement at issue in this Bankruptcy Code case. That argument fails to give effect to Congress' subsequently announced intent that the absolute priority rule have only limited application in cases under the new Chapter 11.[8] The argument rests solely upon its own weight, as neither the United States nor the court of appeals cites any case in which the fair and equitable standard and the absolute priority rule have been applied to a preconfirmation compromise and settlement. Lastly, the argument disregards entirely that the effect of the decision in *Protective Committee* was not to provide protection to senior creditors against compromise of junior debt but was to ensure that the then applicable standards relating to confirmation of Chapter X plans were complied

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[8] The United States fails to distinguish between the generally applicable fair and equitable test for approval of compromises under the *Drexel* standard and the absolute priority rule, which is often described as "fair and equitable" when used as a term of art. Prior to the Fifth Circuit's ruling, the absolute priority technical meaning of "fair and equitable" was never applied to a compromise and settlement.

with so that holders of junior interests were not improperly eliminated from participation in the reorganized debtor.

The attempt by the United States to distinguish the Eighth Circuit's decision in *Flight Transportation* is equally without merit as the factual circumstances in the cases are functionally identical and that case is in direct conflict with the Fifth Circuit. Both cases involve settlements outside of a plan of reorganization; both cases involve the receipt of funds by junior creditors before senior creditors are fully paid; and both cases involve objecting senior creditors. Notwithstanding these similarities, in *Flight Transportation* the Sharing Agreement was approved by the Eighth Circuit under the *Drexel* standard while in this case the Fifth Circuit disapproved the compromise and settlement after applying the absolute priority rule.[9]

The direct conflict between the decision of the Fifth Circuit in this case and the decision of the Eighth Circuit in *Flight Transportation* is further shown by a review of the briefs filed in *Flight Transportation.* There, certain of the objecting senior creditors, citing *Protective Committee*, argued in their brief that the Sharing Agreement violated the absolute priority rule by allowing junior claims to be paid before senior claims. *See* Brief of Appellants, Adams group, at 25-28, *In re Flight Transportation Corp. Securities Liti-*

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[9] Had the Eighth Circuit in *Flight Transportation* applied the absolute priority rule rather than the *Drexel* standard, the settlement at issue in that case could not have been approved because the *Flight Transportation* shareholders, as a junior class, were to receive funds that, had the constructive trust litigation been lost, would have been the property of the bankruptcy estate and available to satisfy the claims of senior creditors.

gation, 730 F.2d 1128 (8th Cir. 1984). The Eighth Circuit rejected that argument by concluding that the Sharing Agreement was a preconfirmation compromise rather than a plan of reorganization and, as such, was not subject to the absolute priority rule or other standards applicable to confirmation of plans. *See* 730 F.2d at 1134 & n.8.

IV.

CONCLUSION

For the foregoing reasons and for the reasons stated in their petition for certiorari, Aweco and United pray that this Court will grant the writ of certiorari and will reverse the judgment of the Fifth Circuit.

Respectfully submitted,

FRANK C. JONES
WALTER W. DRIVER, JR.
JAMES A. PARDO, JR.

KING & SPALDING
2500 Trust Company Tower
Atlanta, Georgia 30303
(404) 572-4600

Attorneys for Petitioner United-American Car Co.

D. M. LYNN
STUART M. REYNOLDS, JR.

MOORE & PETERSON
A Professional Corporation
2800 First City Center
Dallas, Texas 75201-4621
(214) 754-4800

MAHON & WINSTON
2430 One Main Place
Dallas, Texas 75250

Attorneys for Petitioner AWECO, Inc.

CERTIFICATE OF SERVICE

This is to certify that the undersigned, a member of the Bar of this Court, has this day served a copy of the foregoing upon counsel for the Respondent United States of America by causing three copies of the same to be deposited in the United States mail, first-class postage prepaid, addressed as follows:

Rex E. Lee
Solicitor General
Department of Justice
Washington, D.C. 20530

Glenn L. Archer, Jr.
Assistant Attorney General
Department of Justice
Washington, D.C. 20530

Wynette J. Hewett
Elaine F. Ferris
Attorneys
Department of Justice
Washington, D.C. 20530

This 28th day of September, 1984.

WALTER W. DRIVER, JR.

Counsel for Petitioner
United-American Car Co.

KING & SPALDING
2500 Trust Company Tower
Atlanta, Georgia 30303
(404) 572-4600